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THE FEDERAL POWER COMMISSION'S OPINION UPON THE MITCHELL DAM CONSTRUCTION COSTS

I

Intercorporate Contracts

PURSUANT to a provision of the Federal Water Power Act of June 10, 1920,[1] the Alabama Power Company, upon application to the Federal Power Commission, was granted a license for the construction of a hydro-electric project on the Coosa River in the State of Alabama. The project completed, the Power Company in 1930 filed with the Power Commission an itemized statement of the costs incurred in its realization. The Commission then sought to determine from this statement the "actual legitimate original cost" of the project, as required by the Act. Of the $10,646,056 claimed, $5,694,117 was allowed after a detailed examination of the licensee's records and accounts. Further amounts were later disposed of by stipulation between the Commission and licensee,[2] leaving for formal hearing contro-

1. 41 STAT. 1063 (1920), 16 U. S. C. § 791 (1926).
2. Opinion, at 3.

versial accounts aggregating $4,605,735. The present opinion represents the final disposition of these remaining items. The Commission rejected therein the method of power-site valuation proposed by the licensee, based upon the par value of stock given in exchange for the lands at a time of merger with certain other companies and upon a capitalization of savings resulting from hydro production. In its place was adopted a method predicated upon the going market price of the lands at the time of their original acquisition by the Power Company. The Commission also rejected a fee charged upon the construction work by an affiliate, the Dixie Construction Company, allowing for the erection of the dam itself only the direct and overhead expenses of the construction organization. Other less seriously disputed items were allowed or modified.[3]

Though constituting but a fraction of the space utilized in the presentation of its opinion, the Commission's disposition of the question of the Dixie Construction Company's fee strikes directly into what is at the present time one of the gravest problems in public utility control—the regulation of charges made by and between affiliated companies. This fee, totalling $183,540, represented a 3% profit computed upon the direct and overhead costs of the Dixie Construction Company, which held the contract for the erection of the Mitchell Dam. The Alabama Power Company sought to have this item included in its capital account as one of the legitimate costs of construction. Commissions in calculating cost of reproduction have uniformly allowed a contractor's profit on construction work; in this they have been upheld by the courts.[4] But in these cases the assumption has been that there existed between utility and construction company no connection whatsoever. In the present instance, however, the Dixie Company was the wholly owned and controlled subsidiary of the Power Company,[5] and the Commission found in this difference a basis for rejecting licensee's claim.

The intercorporate contract is a product of the holding company form of centralized control. Through it the parent company renders to, or less often, receives from, its subsidiaries certain services including construction of equipment, managerial supervision, and engineering, accounting and

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3. The following discussion is devoted to a consideration of the implications of the Commission's action in disallowing the construction fee charged the licensee by its affiliated company, with passing attention given to the items of less controversial significance. A discussion of the problem of valuation of power-site lands under the Federal Water Power Act will appear in the December issue of the *Journal*.

4. NASH, ECONOMICS OF PUBLIC UTILITIES (2d ed. 1931) 148. Licensee in its original brief cites some of the court and commission cases sustaining this general rule. Brief of Alabama Power Company, at 63.

5. During active construction the ownership of the Dixie Company was transferred to the Winona Coal Company, a wholly owned and controlled subsidiary of the Alabama Traction, Light and Power Company, which in turn held all the Power Company's common stock and through it exercised complete control. See Opinion, 24.

financial aid.[6] For these services charges are made, of which some enter the capital account and others the operating expenses of the benefited company. But in the great majority of such agreements at the present time, the charges are so set as to include a substantial profit element.[7] Because of the community of ownership of subsidiary and parent, there results an accrual of the profit to the same stockholders through two separate channels.[8] It is this use of the intercorporate contract as a double-profit-making device[9] which has provoked criticism and comment.

The Power Commission predicated its rejection of the profit allowance in the *Mitchell Dam* case upon the authority of commissions and courts, under certain circumstances, to disregard separate corporate entities.[10] This doctrine offers one possible legal basis for attack upon the abuses of the intercorporate agreement.[11] On the basis of the tests which courts have set up[12] for the application of this rule to specific factual situations, it

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6. The instant case is one in which the parent secured certain services from its controlled subsidiary. By far the more usual situation is that where the holding company performs services for its subsidiaries.

7. Two large holding companies have recently, however, abandoned management service contracts as a source of profit. They are the Niagara Hudson Power Corporation and the Commonwealth and Southern Corporation, both parts of the United Corporation system. See MOODY'S MANUAL OF PUBLIC UTILITIES (1930) 1557. The Commonwealth and Southern Corporation continues, on the other hand, to do a profitable business with its own subsidiaries with respect to construction work. BONBRIGHT AND MEANS, THE HOLDING COMPANY (1932) 137, note.

8. Under the more usual arrangements where the parent organization performs the services, the holding company secures the profit once through the direct payment made by the subsidiary for the services and again through the inclusion of the charge in the subsidiary's accounts and its consequent consideration in the fixation of the latter's earnings, out of which it pays dividends on its common stock held by the parent company. In an arrangement like that in the *Mitchell Dam* case, the profit accrues to the parent organization by way both of the dividends paid by the subsidiary on its profits and of the earnings allowed on its own accounts, increased by the amount of the profit charge. For an interesting early recognition that intercorporate contracts secure duplicate profits to the dominant company, see Columbus v. Southern Bell Telephone & Telegraph Co., 34 A. T. & T. Co. C. L. 970 (Ga. R. C. 1914).

9. The device has been dubbed the "milking of subsidiaries by parent companies." There can be no doubt of its extended use in recent years. BONBRIGHT AND MEANS, *op. cit. supra* note 7, at 153-154.

10. Opinion, at 25.

11. A committee of the National Association of Railroad and Public Utility Commissioners has expressed the opinion that this doctrine offers a solution for the whole problem of regulation of holding companies. PROC. NAT. ASSOC. R. AND P. U. COMMISSIONERS, Forty-first Annual Convention, 1929, 567. But *cf.* the discussion and citations, pp. 69, 70, *infra*.

12. "Identity of stockholders, identity of officers, the manner of keeping books and records, the methods of conducting the corporate business as a separate concern or as a mere department of the other concern, may be evidential facts to be considered . . . " Ballantine, *Separate Entity of Parent and Subsidiary*

appears that the Commission's position is well taken. There existed a significant interlocking of officers and directors between the Alabama Power Company and the Dixie Company;[13] there obtained a noticeable commingling of accounting affairs during construction;[14] and, although licensee submitted evidence[15] as to the advantages of separate incorporation of the construction company, there was substantial evidence supporting the Commission's view that the Dixie Company was "in substance a department of licensee's own business, maintained during the construction of this and other of its public utility projects with a view to obtaining emoluments and profits not otherwise allowable under the law."[16]

But although available under these circumstances as a legal formula by which profit could be denied on an intercompany agreement, it is extremely doubtful that such a doctrine offers generally to commissions a solution of the problem.[17] The presumption lies in favor of recognizing the separate entities, and the type of evidence required by the courts[18] to overcome this presumption cannot be found in the more common intercorporate relationships, in which domination shades into coordination,[19] and intent

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Corporations (1925) 14 CALIF. L. REV. 12, 18. Identity of officers has been given significant weight in two recent cases. Illinois Bell Telephone Co. v. Moynihan, 38 F. (2d) 77 (N. D. Ill. 1930); State *ex rel.* Daniel v. Broad River Power Co., 157 S. C. 1, 153 S. E. 537 (1929). As to manner and method of conducting the two interrelated businesses, compare the latter case with Berkey v. Third Avenue Ry. Co., 244 N. Y. 84, 155 N. E. 58 (1926), relied upon by licensee. Whether or not the fiction has been used as an evasive device must necessarily be determined from the general factual evidence in each case. Thus, compare Chicago, Milwaukee & St. Paul Ry. Co. v. Minneapolis Civic and Commerce Association, 247 U. S. 490 (1918) with Berkey v. Third Avenue Ry. Co., *supra*.

13. FEDERAL POWER COMMISSION, PRELIMINARY ACCOUNTING REPORT ON ACTUAL LEGITIMATE INVESTMENT IN ORIGINAL MITCHELL DAM PROJECT, NO. 82, ALABAMA POWER COMPANY, LICENSEE, EXHIBIT A.

14. *Id.* at 15-16.

15. Brief of Alabama Power Company, at 52 *et seq.*

16. Opinion, at 25. Of evidential significance in this regard was the fact that Mr. Thurlow, as Vice President and Executive Officer of the construction company, prepared the Dixie's bid and later, as Chief Engineer of the Alabama Power Company, passed upon this bid along with the others submitted. PRELIMINARY ACCOUNTING REPORT, 6.

17. See Greenlaw, *The Regulation of Holding Companies* (1930) 14 ACAD. OF POL. SCI. PROC. 108; Comment (1931) 40 YALE L. J. 809, 811.

18. "It cannot be too strongly emphasized that mere identity of stockholders *per se* does not operate to destroy the distinct corporate existence of two corporations . . . It must further appear by *clear and convincing* evidence that the corporation created is only an adjunct of the business of its creator,—a mere agency, or instrumentality, through which it acts,—a mere business department, or bureau, so to speak." (Italics supplied) Wormser, *Piercing the Veil of Corporate Entity* (1912) 12 COL. L. REV. 496, 504.

19. This distinction between domination and coordination is recognized by Ballantine. Ballantine, *supra* note 12, at 17. The distinction was clearly made

to circumvent prevailing legal restrictions and obligations is not evident.[20] In one case,[21] it is true, the employment of the doctrine in an attack upon the intercorporate contract which the American Telephone and Telegraph Company has with its various subsidiaries, was, in the main, successful.[22] Yet the significance which has been attributed to this case is unmerited. The decision was almost completely devitalized by its later modification,[23] and was expressly rejected in a collateral case tried in a federal court[24] and involving the same litigants. But its importance is most vitiated by another contemporaneous case, involving a subsidiary of the American Telephone and Telegraph Company, which was appealed through the federal courts.[25] In the district court, the city of Chicago[26] urged strongly that the Illinois Company's bill for injunction against the Illinois Commerce Commission be dismissed on the ground that the real party plaintiff was the American Telephone and Telegraph Company. In support, there was introduced an array of evidence purporting to show such a domination of the local company as to render it but a mere instrumentality of the parent. Yet the court found the evidence insufficient[27] to justify a dis-

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in Illinois Bell Telephone Co. v. Moynihan, *supra* note 12, which is discussed in the text *infra*.

20. Berkey v. Third Avenue Ry. Co., *supra* note 12, is illustrative of the usual situation where no clear evidence of intent on the part of the controlling company to evade its obligations is apparent from the parent-subsidiary relationship.

21. People *ex rel.* Potter v. Michigan Bell Telephone Co., 246 Mich. 198, 224 N. W. 438 (1929). The case was brought by the State in the form of a *quo warranto* proceeding to oust the Michigan Company of its franchise on the ground that the American Telephone and Telegraph Company was actually conducting the business in Michigan, with the result that the Michigan Company had violated its franchise.

22. The ouster granted was partial only, relating alone to the right of the subsidiary to have credit in the computation of its rates for contract payments made to the parent.

23. People *ex rel.* Attorney General v. Michigan Bell Telephone Co., P. U. R. 1929E, 27 (Mich. Sup. Ct. 1929). By the modification, the Michigan Company was allowed, upon the making of due proof, to have included in the computation of its rates "the reasonable value of the services rendered and facilities furnished by the American Telephone and Telegraph Company." To allow reasonable value seems to destroy the whole advance made under the original decision.

24. Michigan Bell Telephone Co. v. Odell, 45 F. (2d) 180 (E. D. Mich. 1930). The question of payments under the Bell contract was here raised through the petition of the Michigan Company for an increase in rates.

25. Illinois Bell Telephone Co. v. Moynihan, *supra* note 12, *rev'd* (on grounds not here relevant), Smith v. Illinois Bell Telephone Co., 282 U. S. 133 (1930).

26. The city was permitted to intervene.

27. The evidence offered included annual reports, letters, circulars and bulletins of the American Company intending to show that the Illinois Company was a mere agency with no will of its own, and oral testimony as to alleged instances of dictation. The court found this insufficient mainly on the

regard of the separate entities, and in this was upheld by the Supreme Court in *Smith v. Illinois Bell Telephone Co.*[28] This case seems conclusively to indicate the inadequacy of the disregard-of-corporate-entity doctrine as a basis for control[29] in those instances of parent-subsidiary relationship where the abuse of the intercorporate contract is greatest.[30]

The Solicitor's brief[31] for the Commission in the instant case indicated as a possible basis for regulatory control not only the power just discussed, but also the authority of commissions to disallow unreasonable charges to operating expenses or the capital account. Commissioner McNinch, in his concurring opinion, recognizes this authority as a separate power offering another possible method of control. The majority of the Commission, however, make no mention of it in this connection,[32] and licensee, in its brief,[33] confuses the concept with the entity doctrine. But certainly there exists this independent power of commissions to determine upon the reasonableness of utility charges, and it seems to afford a much more promising legal basis for the accomplishment of adequate control. Well-recognized in law,[34] it is essential to effective regulation under present

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basis of other evidence tending to show that the two corporations were coordinating their activities to produce a unified national service. Thus was the fine line drawn between domination and coordination. See note 19, *supra*. Lack of identity of officers and directors was also of weight. See note 12, *supra*.

28. 282 U. S. 133, 143, 144 (1930).

29. The inadequacy of the doctrine is shown from another angle in the judicial history of a case often cited in its support, Ohio Mining Co. v. Public Utilities Commission, 106 Ohio St. 138, 140 N. E. 143 (1922) See Southern Ohio Power Co. v. Public Utilities Commission, 110 Ohio St. 246, 143 N. E. 700 (1924). From this it appears that a separation of ownership could be secured sufficient to defeat the doctrine, and yet there remain a situation wherein the same objectionable use of intercorporate contracts would be possible.

30. Although the most significant decision in this regard by the Supreme Court, it is not alone, for the Court had earlier indicated that membership in the American Telephone and Telegraph Company does not carry with it the loss of an independent corporate entity. Houston v. Southwestern Bell Telephone Co., 259 U. S. 318 (1922); Southwestern Bell Telephone Co. v. Public Service Commission, 262 U. S. 276 (1923). These decisions, moreover, had defeated a very determined attack by the Maryland Commission upon the relations between the American Telephone and Telegraph Company and its subsidiary in Maryland. Public Service Commission v. Chesapeake & Potomac Telephone Co., P. U. R. 1925B, 545 (Md. P. S. C. 1924). The Commission's contention that the separate identities should be disregarded was rejected by a federal court on the basis of the two Supreme Court decisions above cited. Chesapeake & Potomac Telephone Co. v. Whitman, 3 F. (2d) 938, 957 (D. Md. 1925).

31. Brief for the Commission, 45-47.

32. This is undoubtedly to be explained, however, by the fact that the majority felt it unnecessary to resort to the support of this power. The power is referred to elsewhere in the opinion. Opinion, 26-27.

33. Brief of the Alabama Power Company, at 52 *et seq.*

34. Chicago & Grand Trunk Ry. Co. v. Wellman, 143 U. S. 339 (1892); Tagg Bros. v. United States, 280 U. S. 420 (1930); BONBRIGHT AND MEANS, *op. cit. supra* note 7, at 215.

methods.[35] The action of the Commission in the present case in examining the cost assigned to various items by the licensee in its cost statement, allowing the amounts stated in some instances while reducing them in others, is illustrative of the common exercise of this power by commissions. Entries in the capital account for certain technical advice rendered in connection with the project, and a general administration account covering the estimated expense of departments and officers of the Power Company incurred in connection with supervision and inspection of construction, were taken at the figure set by licensee, the Solicitor for the Commission having found that they were reasonable.[36] Accounts covering taxes and interest during the construction period, and electric power furnished by licensee to the Dixie Company for construction purposes were modified. With regard to the first of these, the Commission merely followed the established practice of the Interstate Commerce Commission and state commissions which recognize two necessary construction periods, one preliminary and the other actual, and on this basis seek to determine from all material facts what is a reasonable length of time for which interest and taxes should be allowed on non-revenue-producing property necessarily tied up in the creation of the project.[37]

The question with regard to electrical energy sold to the Dixie Company was whether the amount to be allowed as payment to licensee for this current should be calculated at the out-of-pocket costs to the latter or whether it should include a proportionate share of licensee's total overhead. What is a proper allowance to be made in such a case must be determined from the relevant facts. If the rates of a utility have been set by a regulatory body with reference to an estimated available market in which there is not included possible sales to subsidiaries, then the overhead of the system has been fully allocated to other purchasers and subsequent sales to controlled companies cannot properly be charged for at more than direct out-of-pocket costs. If, however, possible sales to subsidiaries have been considered in the estimate made of the market available, then an allocated share of overhead should be allowed in the charge when any such sales are later made. Apparently there was no evidence in this case as to which procedure had been followed by the Alabama Public Service Commission in setting the rates of the Alabama Power Company. However, the assumption of the Solicitor for the Commission that licensee's construction jobs were not included in the estimate of available market is supported by the general practice of commissions in excluding such possibilities when estimating probable market demands. The Commission seems justified, under the circumstances, in relying upon the assumption of the Solicitor and allowing as a charge for energy only the amount of the direct increment costs to licensee incurred by reason of its generation of this additional power.

35. See the statement in *Re* Cambridge Home Telephone Co., P. U. R. 1930E, 65, 86 (Ohio P. U. C. 1930).

36. See Brief for the Commission, 50-54, 62.

37. *Re* Texas Midland Railroad, 75 I. C. C. 1, 155-156 (1918); *Re* Idaho Power Co., P. U. R. 1923B, 52, 72-74 (Idaho P. U. C. 1922).

But this power of commissions is not unlimited; they cannot disregard expenditures actually made unless there has been an evident failure on the part of the company's officers to exercise proper business prudence.[38] In the case of purchases of commodities and services, whether or not proper discretion had been exercised seemed to be best capable of determination by looking into what other corporations were paying for like purchases and what it would have cost the company to have secured them from other possible sources. Hence there developed this market value test of reasonableness. With the advent of the public utility holding company, raising the problem of the fairness of intercorporate charges, this same test seems to have been generally carried over to the new situation and applied as it had been in those cases where there had been no connection whatever between buyer and seller.[39] Later, the Supreme Court followed[40] the general tendency in regarding the fact of common ownership of both parties to the contract as "not important" beyond requiring a somewhat closer scrutiny of the situation.[41] The feeling that the market value test of reasonableness was satisfactory even under these peculiar circumstances continued for the most part until very recently.[42] However, not a few

38. See Southwestern Bell Telephone Co. v. Public Service Commission, 262 U. S. 276, 289 (1923), citing from State Public Utilities Commission *ex rel.* Springfield v. Springfield Gas & Electric Co., 291 Ill. 209, 234, 125 N. E. 891, 901 (1919).

39. Birmingham v. Southern Bell Telephone & Telegraph Co., P. U. R. 1919B, 791 (Ala. P. S. C. 1918); *Re* Rates and Charges of Telephone Companies, P. U. R. 1920B, 411 (Ariz. C. C. 1919); *Re* Southwestern Bell Telephone Co., P. U. R. 1921B, 516 (Ark. C. C. 1920); *Re* Mountain States Telephone & Telegraph Co., P. U. R. 1917B, 198 (Colo. P. U. C. 1917); *Re* City of Peoria and Receivers of the Central Union Telephone Co., P. U. R. 1918E, 74 (Ill. P. U. C. 1918); *Re* Central Union Telephone Co., P. U. R. 1920B, 813 (Ind. P. S. C. 1920); *Re* Chesapeake & Potomac Telephone Co., P. U. R. 1916C, 925 (Md. P. S. C. 1916); *Re* Michigan State Telephone Co., P. U. R. 1918C, 81 (Mich. R. C. 1918); Charleston Commercial Club v. Missouri Public Utilities Co., 2 Mo. P. S. C. R. 311 (1915); Buck v. New York Telephone Co., P. U. R. 1921E, 798 (N. Y. P. S. C. 1921); Mangum v. Mangum Electric Co., P. U. R. 1916E, 764 (Okla. C. C. 1916); *Re* Uniform Telephone Rates, P. U. R. 1917D, 259 (Penn. P. S. C. 1917); *Re* Chesapeake & Potomac Telephone Co., P. U. R. 1920F, 49 (Va. S. C. C. 1920); *Re* Chesapeake & Potomac Telephone Co., P. U. R. 1921B, 97 (W. Va. P. S. C. 1920); Bogart v. Wisconsin Telephone Co., P. U. R. 1916C, 1020 (Wis. R. C. 1916). *Contra:* San Jose v. Pacific Telephone & Telegraph Co., 4 Cal. R. C. R. 150 (1914); Columbus v. Southern Bell Telephone & Telegraph Co., *supra* note 8; *Re* Pacific Telephone & Telegraph Co., P. U. R. 1919D, 345 (Ore. P. S. C. 1919). In these three cases cost to the parent company rather than value to the subsidiary was stressed as the dominant factor.

40. Houston v. Southwestern Bell Telephone Co., 259 U. S. 318 (1922); Southwestern Bell Telephone Co. v. Public Service Commission, 262 U. S. 276 (1923).

41. Houston v. Southwestern Bell Telephone Co., 259 U. S. 318, 323 (1922).

42. ". . . the test seems to be whether the sum [paid to the parent company] is greater than the operating company would be compelled to pay

commissions were beginning to question the efficacy of such a test, contending that because of the community of interests involved in intercorporate charges, the going market price paid by others was not indicative of the reasonableness of such payments, which could be adequately determined only by reference to the cost to the selling company.[43] A fuller understanding in recent years of the implications of the public utility holding company has given rise to a general conviction of the soundness of this contention.[44] The Supreme Court has twice indicated its abandonment of the market value test.[45] In the *Smith* case, involving the two-fold problem of payments by Bell subsidiaries to the American Company for services and to Western Electric for equipment, the Court held in effect that, because of the common ownership of these companies, the reasonableness of payments by the subsidiaries was not shown by a comparison of those amounts with market value, but could only be determined after spe-

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to independent agencies for the same services or commodities, or than it would cost the operating company to supply the services through its own organization. The thought seems to be that if the holding company receives for its services or commodities furnished to its controlled subsidiary no more than the subsidiary would have to pay for the same services or commodities under conditions of competition in dealing with outsiders, the charge cannot be said to be unreasonable. . ." Lilienthal, *The Regulation of Public Utility Holding Companies* (1929) 29 COL. L. REV. 404, 419. No attempt is here made to collect the many court and commission cases in which this test was employed during the period of time elapsing between the decision of the Federal Supreme Court in the *Houston* case and its decision in the *Smith* case, discussed in the text, *infra.*

43. *Re* Southern California Telephone Co., P. U. R. 1925C, 627 (Cal. R. C. 1924); *Re* Pickwick Stages System, P. U. R. 1928D, 310 (Cal. R. C. 1928); *Re* Pickwick Stages System, P. U. R. 1928D, 604 (Cal. R. C. 1928); *Re* Pacific Telephone & Telegraph Co., P. U. R. 1930C, 481 (Cal. R. C. 1929); Illinois Commerce Commission v. Chicago, P. U. R. 1924A, 213 (Ill. C. C. 1923); *Re* Indiana Bell Telephone Co., P. U. R. 1924A, 1 (Ind. P. S. C. 1923); Public Service Commission v. Chesapeake & Potomac Telephone Co., P. U. R. 1925B, 545 (Md. P. S. C. 1924); *Re* Michigan State Telephone Co., P. U. R. 1923A, 30 (Mich. P. U. C. 1922); *Re* Northwestern Bell Telephone Co., P. U. R. 1923B, 112 (Neb. R. C. 1922); *Re* New York Telephone Co., P. U. R. 1925C, 767 (N. J. P. U. C. 1924); *Re* Dayton Power & Light Co., P. U. R. 1931A, 332 (Ohio P. U. C. 1930); *Re* Chesapeake & Potomac Telephone Co., P. U. R. 1926E, 481 (Va. S. C. C. 1926); *Re* Wisconsin Fuel & Light Co., P. U. R. 1927E, 212 (Wis. R. C. 1927); *Re* City Water Co. of Marinette; *Re* City Water Works Co. of Merrill, both 30 Wis. R. C. R. 352 (1927). One federal court during this time also felt the necessity of referring to cost in order to test the reasonableness of allowances made for purchases from an affiliated concern in calculating cost of reproduction. New York Telephone Co. v. Prendergast, 36 F. (2d) 54 (S. D. N. Y. 1929).

44. The utility interests, however, seem for the most part to continue to support the market value test. Insull, *Is Control of Holding Companies Sufficient?* (1930) 14 ACAD. OF POL. SCI. PROC. 81, 86. See also NASH, *op. cit. supra* note 4, at 414-416. But *cf.* note 7, *supra.*

45. Smith v. Illinois Bell Telephone Co., 282 U. S. 133 (1930); Western Distributing Co. v. Public Service Commission, 285 U. S. 119 (1932).

cific findings on the cost to, and profits of, the central organizations.[46] In *Western Distributing Company v. Public Service Commission*, where payments by a subsidiary to Cities Service Company were in question, the court reiterated its conclusion that a commission is entitled to know and consider the real cost to a parent of services and commodities sold to a subsidiary, and indicated more clearly its reasons for so holding. These were that the unity of control and interest between buyer and seller create a situation totally different from that where the two companies are "dealing at arm's length" and gives a power "arbitrarily to fix and maintain costs, as respects the distributing (*i. e.*, the subsidiary) company which do not represent the true value of the services rendered . . . "[47] Since the decision in *Smith v. Illinois Bell Telephone Company*, courts and commissions have quite uniformly indicated a determination to test the propriety of charges arising in interlocking organizations by considering the cost and profit to the parent companies.[48]

From its nature, the regulatory power over reasonableness of operating and capital account charges, unlike that of disregard of separate corporate entities, was one not restricted in scope to instances of dominating parent control. Rather, it was wholly independent of the degree of existing control and thus capable of exercise in all the varied parent-subsidiary relationships out of which were arising the practices sought to be curbed. Circumscribed as it was by the market value test, however, it could be but of little avail. Only because of its extension in the last few years has it come to offer a promising legal basis for the adequate control of charges made under intercompany contracts.[49] But now there is added to its advantage of inclusiveness the fact that courts and commissions are thereby enabled to look

46. See the Wisconsin Public Service Commission's interpretation of the significance of the Supreme Court's ruling, in *Re* Wisconsin Telephone Co., P. U. R. 1931E, 101, 119 (Wis. P. S. C. 1931).

47. Western Distributing Co. v. Public Service Commission, 285 U. S. 119, 126-127 (1932).

48. Michigan Bell Telephone Co. v. Michigan Public Utilities Commission, P. U. R. 1931E, 222 (U. S. Dist. Ct. E. D. Mich. 1931) (sustaining the Michigan Commission in its demand for evidence relating to the cost to Western Electric of manufacturing equipment sold to subsidiaries); *Re* New Hampshire Gas & Electric Co., P. U. R. 1931D, 225 (N. H. P. S. C. 1931); *Re* Columbus Gas & Fuel Co., P. U. R. 1931C, 244 (Ohio P. U. C. 1931) (but *cf. Re* Warren Telephone Co., P. U. R. 1932A, 416, 420); *Re* Wisconsin Telephone Co., *supra* note 46.

49. The problem of securing a satisfactory legal basis for effective control of intercorporate charges is not to be confused with that concerning the proper governmental unit for exercising the control available. For some of the problems involved in the question of whether or not federal regulation of holding companies is necessary, see Lilienthal, *Recent Developments in the Law of Public Utility Holding Companies* (1931) 31 COL. L. REV. 189, 205. Nor should the problem here under discussion fail to be distinguished from that as to whether or not abuses of the holding company other than excessive profit-making through intercompany contracts can be adequately controlled under existing regulatory authority.

behind the intercorporate agreement to the cost and profit arising thereunder, and thus may maintain an effective restraint upon the use of this profit device.

In what, however, is this restraint particularly to consist? Is all profit to be disallowed or only what is deemed to be excessive profit? The decision in the *Mitchell Dam* case, rejecting all profit and allowing only the direct and overhead cost on the construction work performed by the Dixie Company, raises this important problem. Although there has been expressed some belief to the contrary,[50] it seems clear that the Supreme Court under its new attitude has not adopted cost to the selling company as the measure of reasonableness.[51] Nor have commissions equated reasonableness to this standard to the extent often supposed. A study of the decisions wherein they have departed from the market value test of propriety reveals but few instances[52] in which the amount of the payment allowed has been limited to the direct and overhead cost to the company furnishing the services or commodities. In the other cases,[53] though the language may seem to indicate as much, [54] there has been no such limitation attempted.[55]

One criticism of the adequacy of commission power over the reasonableness of operating expenses and additions to the capital account as a satisfactory legal basis for control of intercompany charges has been advanced. It is to the effect that the commission's power to disallow unreasonable charges cannot prevent a utility company from paying an excessive amount to its holding company and thereby weakening its credit position. BONBRIGHT AND MEANS, *op. cit. supra* note 7, at 181-182.

50. Comment (1931) 19 CAL. L. REV. 431, 438; Comment (1931) 40 YALE L. J. 809, 814.

51. This is the interpretation placed upon the Supreme Court's decisions by Commissioner McNinch in his concurring opinion in the instant case. Opinion, at 53. The same interpretation is to be found in Bonbright and Means, *op. cit. supra* note 7, at 217; Lilienthal, *supra* note 49, at 197-198; Michigan Bell Telephone Co. v. Michigan Public Utilities Commission, *supra* note 48; *Re* Wisconsin Telephone Co., *supra* note 46; Comment (1931) 9 N. C. L. REV. 463, 466.

52. Columbus v. Southern Bell Telephone & Telegraph Co., *supra* note 8; San Jose v. Pacific Telephone & Telegraph Co., *supra* note 39; *Re* Pickwick Stages System (two cases); *Re* Pacific Telephone & Telegraph Co.; *Re* Indiana Bell Telephone Co.; *Re* Michigan State Telephone Co., all *supra* note 43.

53. *Re* Pacific Telephone & Telegraph Co., *supra* note 39; notes 43 and 48, *supra*.

54. The confusion as to the actual holdings in these decisions seems to arise both from the uncritical use by commissions of the term *cost* and from their efforts to solve the distinct though related problem of determining whether or not payments calculated upon bases which in themselves have no meaning, *e.g.* certain percentages of gross revenues, can be substantiated by evidence of actual services performed or commodities furnished. The distinction between this problem and the one under discussion, viz. that of determining whether or not the amounts actually paid on whatever the basis of charging employed are reasonable, is indicated in Lilienthal, *supra* note 42, at 416, 419. *Re* Tucson Gas, Electric Light & Power Co., P. U. R. 1922C, 658 (Ariz. C. C. 1922), sometimes cited as a cost case, actually involved this related problem.

55. A few decisions are in such form that it is difficult to determine the position which the commission intended to take. *Re* New Hampshire Gas &

This is true even of the decisions of the Wisconsin Commission, which has many times been cited[56] as one equating charges to costs. Thus in those instances where the Commission has acted upon the precise question of the reasonableness of sums actually paid under intercompany agreements, though holding that charges, in order to be considered reasonable, should bear a "close relation to the cost of the holding company of performing the service,"[57] it has merely declared that *"a fair share of the economies"* arising out of integrated control should be passed on to the consumer.[58] It is in those cases in which the Commission is insisting upon referring to cost as proof that services or commodities have actually been supplied under these contracts,[59] that language is employed which seems to commit the Commission to cost as the test of reasonableness.[60] In recent years, only California appears to have made any outright adoption of this measure.[61] The Commission of that state has iterated a policy of refusing to allow a construction company "to profit at the expense of a public utility when the construction company controls the public utility or is owned or controlled by the same interests which own or control the utility."[62] It is clear, then, that there have been but few attempts to set up cost as in

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Electric Co., *supra* note 48; Public Service Commission v. Chesapeake & Potomac Telephone Co., *supra* note 30.

56. See, *e.g.*, Wright, *Management Fees of Public Utility Holding Companies* (1930) 6 JOUR. LAND AND PUBLIC UTILITY ECON. 415, 419; NASH, *op. cit. supra* note 4, at 413.

57. *Re* Wisconsin Fuel & Light Co., *supra* note 43, at 214; *Re* City Water Co. of Marinette; *Re* City Water Works Co. of Merrill, both *supra* note 43.

58. *Re* Wisconsin Telephone Co., *supra* note 46, at 118. Italics the Commission's. The attitude of the Commission here is especially significant in that it was expressed after, and represents an interpretation of, the *Smith* case.

59. See note 54, *supra*. The Wisconsin Commission itself clearly recognizes the two distinct problems raised in these cases. See its opinion *In Re* Wisconsin Fuel & Light Co., *supra* note 43.

60. *Re* Wisconsin Telephone Co., 28 Wis. R. C. R. 351 (1925); *Re* Wisconsin Telephone Co., P. U. R. 1927A, 581 (Wis. R. C. 1926); *Re* St. Croix Valley Telephone Co., P. U. R. 1929B, 597 (Wis. R. C. 1929); *Re* Wisconsin Telephone Co., Decisions U-3683, U-3884, and U-3900 (Wis. R. C. 1930).

61. As indicated in note 55, *supra*, the New Hampshire Commission has recently shown what may perhaps be a tendency toward the adoption of the cost basis.

62. *Re* Pickwick Stages System, 30 Cal. R. C. R. 761, 763 (1927); *Re* Pickwick Stages System, P. U. R. 1928D, 310; *Re* Pickwick Stages System, P. U. R. 1928D, 604 (both Cal. R. C. 1928). Later this policy was enforced with respect to payments made by the Pacific Coast Bell subsidiary to Western Electric. *Re* Pacific Telephone & Telegraph Co., *supra* note 43. There have apparently been no appeals taken from these decisions. Thus the California Commission seems to fully continue in the policy which it early adopted in San Jose v. Pacific Telephone & Telegraph Co., *supra* note 39. But *cf.* its statement in *Re* Southern California Telephone Co., *supra* note 43, to the effect that cost is *one* factor to be considered.

itself the test of reasonableness. Rather, commissions and courts have either sought only to restrict the profit on intercorporate contracts to a reasonable sum[63] or have merely insisted upon the production of cost data, leaving unindicated as yet their position on the question of the allowance or disallowance of a profit increment.[64]

This question is of significance because it involves the problem of the reward of efficient management. It has been urged that if parent organizations are prevented from making charges to their subsidiaries which will include a profit over and above the cost to them of the services rendered or the commodities delivered, they will be under no inducement to realize the economies possible through centralized organization.[65] Thus counsel for the Illinois Bell Telephone Company, in answer to the contentions pressed by the City of Chicago in the *Smith* case,[66] declared on oral argument that "I see no reward [under such a theory] for management then. I see no reason why a company should attempt to give the best service at the lowest cost."[67] And this view has been regarded as persuasive by other than utility representatives.[68] The problem will be recognized as but an old one in new form,[69] for the whole theory of utility regulation has often been criticized[70] on the ground that it tends to induce inefficiency, since the utility "may feel that its rates will be adjusted to give it the same rate of return whether it makes improvements or not, so that

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63. *Re* Pacific Telephone & Telegraph Co., *supra* note 39; *Re* Northwestern Bell Telephone Co.; New York Telephone Co. v. Prendergast; *Re* Chesapeake & Potomac Telephone Co.; *Re* Wisconsin Fuel & Light Co.; *Re* City Water Co. of Marinette; *Re* City Water Works Co. of Merrill, all *supra* note 43; *Re* Wisconsin Telephone Co., *supra* note 46.

64. Smith v. Illinois Bell Telephone Co., 282 U. S. 133 (1930); Western Distributing Co. v. Public Service Commission, 285 U. S. 119 (1932); Illinois Commerce Commission v. Chicago; *Re* New York Telephone Co.; *Re* Dayton Power & Light Co., all *supra* note 43; Michigan Bell Telephone Co. v. Michigan Public Utilities Commission; *Re* Columbus Gas & Fuel Co., both *supra* note 48.

65. That there are substantial economies possible under the holding company form of business integration is generally acknowledged as to direct holding company control of operating subsidiaries. Flynn, *Pyramiding of Holding Companies* (1932) 159 ANN. AM. ACAD. 15; Hodge, *A Defense of the Holding Company*, *id.* at 7; Ruggles, *Regulation of Electric Light and Power Utilities* (1929) 19 AM. ECON. REV. (Supp.) 179; Sickler, *Regulation of Public Utility Integration on the Pacific Coast* (1930) 6 JOUR. LAND AND PUBLIC UTILITY ECON. 51. But *cf.* Bonbright, *The Evils of the Holding Company* (1932) 159 ANN. AM. ACAD. 1.

66. See p. 70, *supra*.

67. Cited in Lilienthal, *supra* note 49, at 204.

68. Bonbright, *"Recent Developments in the Law of Public Utility Holding Companies"—A Comment* (1931) 31 COL. L. REV. 208; Wright, *supra* note 56.

69. *Cf.* Bonbright, *supra* note 68, at 211.

70. See BAUER, EFFECTIVE REGULATION OF PUBLIC UTILITIES (1925) 328; CLARK, SOCIAL CONTROL OF BUSINESS (1926) 384-385; NEW YORK STATE COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSIONS LAWS (1930) VOL. I, *Recommendations of Commissioners* 383.

the public will get the entire benefit."[71] That problem is as to whether efficient management does in reality find its own reward or whether a definite reward must be allowed directly in the process of regulation. That the latter is necessary has been the view taken by various writers on economics,[72] engineers,[73] and commissions.[74] On the other hand it has been urged by some[75] that no definite allowance need be made in regulation for managerial reward, there being indirect sources of gain whereby efficient management secures for itself ample recompense.[76] These incentives are said to include the possibility of strengthening the credit rating of securities through achieving greater stability of earnings, the lack of a guarantee of earnings by the regulating authority,[77] the fact that earnings above the fair return may be retained by the utility,[78] and the probability that through voluntary rate reductions made possible by

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71. CLARK, *op. cit. supra* note 70, at 385.

72. *Ibid.*; Ruggles, *supra* note 65; *cf.* NEW YORK STATE COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSIONS *Law*, *op. cit. supra* note 70, at 383 *et passim.*

73. See the testimony of R. T. Livingston, consulting engineer of the Long Island Lighting Company, NEW YORK STATE COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSIONS LAW (1930) VOL. III, at 2414 *et seq.*, especially p. 2422.

74. The commission cases in which a definite allowance has been made for efficiency in management are collected in SPURR, GUIDING PRINCIPLES OF PUBLIC SERVICE REGULATION (1926) VOL. III, 97-111. See also SMITH, THE FAIR RATE OF RETURN IN PUBLIC UTILITY REGULATION (1932) 198; SMITH AND DOWLING, CASES ON PUBLIC UTILITIES (1926) 1081-1085. *Cf.* the statement of Chairman Attwill of the Massachusetts Department of Public Utilities, Attwill, *Weaknesses of the Valuation System* (1932) 159 ANN. AM. ACAD. 96, 97, and the remarks of Mr. Justice Brandeis during the oral argument in the *Smith* case, cited in Lilienthal, *supra* note 49, at 204, note.

75. Bauer, *"Regulation of Electric Light and Power Utilities"—Discussion* (1929) 19 AM. ECON. REV. (Supp.) 219, 222; SMITH, *op. cit. supra* note 74, at 73; Testimony of Judson C. Dickerman, public utility expert, NEW YORK STATE COMMISSION ON REVISION OF THE PUBLIC SERVICE COMMISSIONS LAW (1930) VOL. III, at 2423-2424.

76. The abandonment of profit charging by the Niagara Hudson Power Corporation and (partially) by the Commonwealth and Southern Corporation, discussed *supra* note 7, gives strength to this contention.

77. This factor is at the present time more significant in those cases where fair value is taken as the rate base than in those where actual investment constitutes the base, because of the present liberality of courts in determining fair value. Cases, such as the instant one, where valuation is governed by the provisions of the Federal Water Power Act clearly fall within the latter group. 41 STAT. 1064 (1920), 16 U. S. C. § 796 (1926).

78. Under a recapture provision or a provision for the payment of excess earnings into a rate equalization reserve, this incentive would be absent. It would thus not be present for utility organizations operating under the Federal Water Power Act because of the provision therein for recapture of earnings over a fair rate of return. 41 STAT. 1069 (§§ 9d-9e) (1920), 16 U. S. C. §§ 803d-803e (1926).

excellence in management, the volume of business can be expanded and a situation created for the investment of new capital under advantageous conditions. The adherence to either of these positions will raise unique problems. Thus if cost is taken as the measure of reasonableness, the situation will become extremely complicated in those instances where the parent company has a working control of the subsidiary but does not own a large proportion of the latter's stock. In the cases which have so far been before the courts and commissions, especially those involving the Bell system, stock ownership of the controlled subsidiary has been relatively complete. But control and ownership need not be congruent,[79] and indeed often are not,[80] and under such circumstances the disallowance of all profit on intercompany contracts would be unduly prejudicial to the organization rendering the services or furnishing the commodities.[81] On the other hand, if the position be taken that some direct allowance should be made for efficiency, the question arises as to the proper method. Where attention has been directed to the problem of encouraging operating company management, as distinct from the holding company type of management, by far the usual method suggested and employed has been that of

79. To effect absolute control a parent company need hold but a fraction over 50 per cent of the outstanding voting stock of the subsidiary. Yet a holding company can in most cases achieve a factual control just as effective, with only a minority interest. This arises primarily from the fact that the remaining voting stock is usually widely distributed among various shareholders who have no unity of interest, and from the further fact that in some instances friendly, though independent, interests have substantial holdings. Thus Electric Bond & Share Co. has only minority interests in the subholding companies through which it contracts with operating companies for financial, managerial and engineering supervision. See Federal Trade Commission, *Control of Electric Power Companies* (1927) 69th Cong., 2d Sess., Sen. Doc. 213, at 7. Yet the Federal Trade Commission "has expressed a conviction, which is generally sustained in the investment world, that Electric Bond & Share Company does enjoy *de facto* control. . ." BONBRIGHT AND MEANS, *op. cit. supra* note 7, at 103.

80. The recently published study of the Federal Power Commission reveals numerous instances in which the holding company has far less than a 100 per cent stock interest in the operating subsidiary. See Federal Power Commission, *Holding Company Control of Licensees of the Federal Power Commission* (1932). See also note 79, *supra*.

81. One possible solution is suggested. The objection to the allowance of a profit increment being that it enables the stockholders of the parent company to realize the profit twice over, to the extent that the fee charged would return to the parent a second time it would be disallowed, but allowed to the extent that it would not thus return. The relative amounts of stock owned by the parent and by outside interests would be the determining factor. Thus assuming that in the *Mitchell Dam* case the Alabama Power Company held but 40 per cent of the Dixie Company's stock, then 60 per cent of the fee charged would be allowed as an item in the Power Company's capital account. The criticism of such a proposal is its probable unworkability in situations of involved intercorporate payments and complicated capital structures.

making a differential allowance in the rate of return.[82] This method has been advanced as desirable for the rewarding of efficiency on the part of holding company organizations[83] and perhaps its use would best enable commissions intelligently to make an adequate, and at the same time not excessive, allowance for this factor. Substantial criticism may, however, be urged against it,[84] especially until more objective tests are available for determining the differential to be employed.[85]

As between the two positions regarding the allowance or disallowance of a profit increment in intercompany agreements, the Federal Power Commission in the instant case elected the latter. Certainly the peculiar facts and circumstances of this case, indicated earlier in this discussion,[86] justify the Commission in its decision. The question remains, however, as to the proper disposition of the many cases involving the intercorporate contract wherein the parent-subsidiary relationship more fully vindicates its existence.

THE PACKER CONSENT DECREE*

SINCE 1889 investigations of the large meat packers[1] have been frequent. In response to public clamour, a Senate investigation[2] of the meat trust was largely responsible for the passage of the Sherman Act.[3] The first court action taken by the Department of Justice against the big packers was in 1902, when it secured a temporary injunction, made permanent

82. See notes 72, 73, and 74, *supra.*
83. Ruggles, *supra* note 65, at 191-192.
84. Bauer, *supra* note 75, at 221-222.
85. After an extensive study of the general problem of rewarding efficiency in management, one writer concludes that liberality in the allowance of operating and capital account charges is preferable to the inclusion of a differential in the rate of return. SMITH, *op. cit. supra* note 74, at 199.
86. See p. 69, *supra.*

* Special acknowledgement is made of the valuable bibliographical assistance given by Mrs. Madge E. Harkness of the Federal Trade Commission Library.

1. Throughout this article, whenever "big packers," the "Big Five" or the "Big Four," or just the "packers" without qualification appears, reference is had to Swift & Co., Armour & Co., Morris & Co., Wilson & Co. (Inc), and the Cudahy Packing Co. In 1923 Armour & Co. absorbed Morris & Co. and the packers became the "Big Four" instead of the "Big Five."
2. VEST REPORT, SEN. DOC. No. 829, Vol. 3, 51st Cong., 1st Sess. (1889). The committee reported collusion in regard to (1) fixing prices of beef, (2) division of territory and business, (3) division of certain public contracts and (4) compulsion of retailers to buy their beef from the packers.
3. 26 STAT. 209 (1890), 15 U. S. C. § 1 (1926).

one year later,[4] forbidding further violations of the Sherman Act and specifically enjoining the further operation of the notorious Veeder pool.[5] As a result of the temporary injunction and to circumvent its provisions, the three principal members[6] of the old pool immediately attempted to effect a merger. Due to the withdrawal of support by Kuhn, Loeb & Co., who were to finance the deal, the merger fell through. Shortly thereafter the National Packing Co. was formed, to which the various big packers transferred certain of their subsidiary packing companies. The principal officers of the big packers, the same men who had met in Veeder's office to attend the manipulations of the old pool, could meet, as directors of the new corporation, with small risk of contempt proceedings.

The next judicial action against the packers was the famous "immunity bath" case[7] where a verdict in favor of the defendant officers of the packing companies was directed in a criminal prosecution because certain of the individual defendants had given information to the Commissioner of Corporations in an inquiry into the prices of cattle and dressed beef instituted by order of the House of Representatives.[8] A further indictment was returned against the Swift, Armour and Morris groups of defendants in 1910 for their part in the organization and continued operation of the National Packing Co. After claims of immunity [9] and demurrers [10] were

4. U. S. v. Swift & Co., 122 Fed. 529 (C. C. N. D. Ill. 1903); *aff'd*, 196 U. S. 375 (1905).

5. Original decree, 196 U. S. 375, 393N (1905); perpetual injunction as modified by mandate of Supreme Court in 196 U. S. 375 (1905). See FEDERAL TRADE COMMISSION, 2 REPORT ON MEAT PACKING INDUSTRY 18. Representatives of the leading packing companies met regularly every Tuesday afternoon, divided the territory and apportioned the volume of business to be done by each, penalties being levied when anyone of them exceeded his allotment in any territory. *Id.*, Summary, at 46-47.

6. Armour, Swift and Morris.

7. U. S. v. Armour & Co., 142 Fed. 808 (N. D. Ill. 1906). The Commissioner of Corporations, whose duty it was to make this inquiry, had the power to subpoena the books and correspondence of any individual or corporation where such material was relevant to the inquiry and to subpoena witnesses for the same purpose. This power was subject to the immunity statute immunizing persons from prosecution on account of anything testified to in proceedings under the Sherman Act. The Commissioner, however, did not subpoena any of the defendants in this case but they voluntarily appeared before him. Judge Humphreys held that the only object of the subpoena was to secure attendance and it is superfluous when the witness is present without subpoena, and the mere fact that the Commissioner of Corporations did have the power to force the defendants to testify granted them immunity for acts to which they had testified without testimonial compulsion.

8. H. R. Doc. No. 382, 58th Cong. 3d Sess., REPORT OF THE COMMISSIONER OF CORPORATIONS ON THE BEEF INDUSTRY (March 3, 1905); see Francis Walker, *The "Beef Trust" and the United States Government* (1906) 16 ECONOMIC JOURNAL 491.

9. U. S. v. Swift & Co., 186 Fed. 1002 (N. D. Ill. 1911).

10. U. S. v. Swift & Co., 188 Fed. 92 (N. D. Ill. 1911).

overruled the defendants were acquitted, but threat of a civil suit resulted in dissolution of the National Packing Co. and distribution of its assets among the three stockholding packers.

In 1917 the President directed the Federal Trade Commission to investigate the meat packing industry, the Commission's report being published in 1919.[11] This report stated that the packers, together with their subsidiaries and affiliates, not only had "a monopolistic control over the American meat industry but have secured control similar in purpose, if not yet in extent, over the principal substitutes for meat, such as eggs, cheese, and vegetable-oil products, and are rapidly extending their power to cover fish and nearly every kind of foodstuff. . . . The monopolistic position of the Big Five[12] is based not only on the large proportion of the meat business which they handle, ranging from 61 to 86 per cent[13] in the principal lines but primarily on their ownership, separately or jointly, of stockyards, private refrigerator car lines, cold storage plants, branch houses, and the other essential facilities for the distribution of perishable foods. . . .

"There are undoubtedly rivalries in certain lines among the five corporations. Their agreements do not cover every phase of their manifold activities, nor is each of the five corporations a party to all the agreements and understandings which exist. Each of the companies is free to secure advantages and profits for itself so long as it does not disturb the basic compact. Elaborate steps have been taken to disguise their real relations by maintaining a show of intense competition at the most conspicuous points of contact."[14]

Following the disclosures made by the Federal Trade Commission, the Department of Justice in 1919, according to official announcements, was

11. F. T. C., REPORT ON THE MEAT PACKING INDUSTRY (1919).

12. Armour, Swift, Morris, Wilson and Cudahy.

13. In 1916 the big packers' percentage of the interstate slaughter, including subsidiary and affiliated companies, was as follows: cattle, 82.2%; calves, 76.6%; hogs, 61.2%; sheep and lambs 86.4%. There was only one independent packer—Kingan & Co.—who slaughtered as much as one per cent of the interstate total of cattle, and only nine independents who slaughtered as much as one per cent of the interstate total of hogs.

14. *Supra*, note 11, summary, at 31-32. The Commission stated that "the power of the Big Five in the United States has been and is being unfairly and illegally used to manipulate livestock markets; restrict interstate and international supplies of foods; control the prices of dressed meats and other foods; defraud both the producers of food and consumers; secure special privileges from railroads, stockyard companies and municipalities." p. 32. "Control of the meat industry carries with it not only control of all kinds of fresh and preserved meats, but in addition a very great competitive advantage in more than a hundred products and by-products arising in connection with their preparation and manufacture, ranging in importance from hides and oleomargarine to sandpaper and curled hair. In all these lines the Big Five's percentage of control as compared with other slaughterers is greater even than the percentage of animals killed, because of the fact that many of the smaller packers are not equipped or have been unable to use all their by-products." pp. 33-34.

preparing to present to a Federal grand jury in New York evidence of a combination in the meat packing industry in violation of the anti-trust laws with a view to procuring an indictment. Negotiations with the Department of Justice, initiated by the packers in the fall of 1919, resulted in the suspension of the grand jury proceedings and the application to the civil courts for a decree to which both parties consented. On February 27, 1920, the Attorney General filed suit in the Supreme Court of the District of Columbia, alleging an unlawful combination and asking for relief. By prearrangement, the case was not contested, and a consent decree was entered on the same day that the petition was filed. By the terms of this decree the five big companies[15] and certain subsidiary or affiliated corporations, and certain individuals connected with the corporate defendants, were enjoined and restrained from maintaining or entering into any contract, combination, or conspiracy in restraint of interstate trade, or from monopolizing or attempting to monopolize any part of interstate trade or commerce.

The defendants were required, among other things, to dispose of their holdings in public stockyards, stockyard railroads and terminals; to dispose of their interest in market newspapers and in public cold storage warehouses except where necessary for their own meat products; to dissociate themselves from the retail meat business; to discontinue using and to allow no one else to use their facilities for the purchase, sale, distributing, etc. of certain commodities commonly referred to as "unrelated lines" (consisting principally of wholesale groceries); to dissociate themselves from ownership of any capital stock in corporations engaged in manufacturing, selling, distributing, or otherwise dealing in such unrelated commodities; to cease dealing in fresh milk or cream. Individual defendants were enjoined from owning severally or collectively, more than 50 per cent of the voting stock of any corporation or a half interest or more in any firm or association engaged in dealing in any manner in the enumerated unrelated commodities.

A two year time limit was set for the fulfillment of the changes decreed. The packer defendants consented to the decree upon the condition that their consent would in no way constitute an admission, or the decree itself an adjudication that the defendants had in fact violated any law of the United States.[16]

The government by this decree subjected the packers to much greater restraints than would have been possible in an injunction issued after a

15. Armour & Co., Swift & Co., Wilson & Co. (Inc.), Morris & Co., and the Cudahy Packing Co.

16. The packers claimed in their answer to the government's petition that they had violated no law and stated that they merely bowed to the will of the people. The Attorney General claimed on the other hand that the packers made a complete submission to the government. It would seem that the statement of the Attorney General was more reasonable and that the packers' answer and consent to the decree practically amounted to a plea of *nolo contendere.*

litigated suit. If the suit had been contested no provisions could have been inserted in the decree other than those which enjoined the illegal practices of the defendants. The requirements of abandoning dealing in unrelated lines, milk and cream, and engaging in retail trade, prohibitions which proved most irksome to the packers, could not have been inserted as there was no violation of the anti-trust laws in the packers' engaging in these lawful businesses in a lawful manner.

From the haste with which subsequent attack on the decree was begun, there is some indication that from the time the decree was entered the packers intended to attack it. The first move was a request to the Attorney General in 1921 by the California Co-operative Canneries to have the decree modified. While this request was being considered by the Attorney General, the Southern Wholesale Grocers Association and the National Wholesale Grocers Association were granted leave, over the Attorney General's objection, to intervene in any proceedings which might be had to modify the consent decree. Thereafter, the Attorney General secured the appointment of an interdepartmental committee of three[17] to consider the advisability of modifying the decree. After hearing a large number of witnesses, the committee declared that questions of such vital interest to the public generally were matters which ultimately must be decided by the court issuing the decree and recommended that the issues should not be in any manner prejudged by the Attorney General.[18] This position was adopted by the Attorney General who, therefore, made no recommendation to the court.

Accordingly, in 1922 the California Co-operative Canneries[19] brought suit to intervene to have the decree vacated or modified in order to permit Armour & Co. to engage in the unrelated lines upon the ground that the decree interfered with its contract that Armour & Co. should market its production. Intervention was denied by the Supreme Court of the District of Columbia, which was sustained by the U. S. Supreme Court[20] in 1929 after a contrary holding in the Court of Appeals of the District of Columbia.[21] Upon the motion of the California Canneries the trial court had

17. This committee was composed of one member selected by the Secretary of Agriculture, one by the Secretary of Commerce and Mr. Herman J. Galloway, Special Assistant to the Attorney General, who had been actively connected with the case.

18. REPORT OF THE INTERDEPARTMENTAL COMMITTEE, Jan. 20. 1922, printed as Exhibit B, Hearings before a Subcommittee of the Committee on Agriculture and Forestry, U. S. Senate, sixty-seventh Congress, 2d session, at 14.

19. The record in the present case (p. 715) shows the close financial relationship between California Canneries and Armour & Co. At the time of the trial the California Canneries owed Armour & Co. over $1,400,000. In addition Armour had guaranteed accounts on which California Canneries owed $350,000.

20. 279 U. S. 553 (1929).

21. 299 Fed. 908 (App. D. C. 1924). The Supreme Court held that, under the Expediting Act of Feb. 11, 1903, 32 STAT. 823 (1903), 36 STAT. 854 (1910), 15 U. S. C. §§ 28, 29 (1926), requiring all suits in equity brought by the United States under the anti-trust act to be appealed directly to the Supreme Court from the trial court, the Court of Appeals had no jurisdiction.

entered an order, dated May 1, 1925, suspending the further operation of the consent decree until after a full hearing on the merits could be had. While the litigation in this suit was pending, Swift and Armour moved in the Supreme Court of the District of Columbia that the consent decree be declared void for lack of jurisdiction.[22] From an order overruling these motions, the petitioners took appeals to the Court of Appeals of the District of Columbia, from which the case was certified to the U. S. Supreme Court.[23] In 1928, the Supreme Court handed down its decision in the certified case, upholding the consent decree. It was held that an injunction against the packers was proper, even though past wrongs had neither been proved nor admitted, and that even if the court, having jurisdiction of the subject and parties, had erred in deciding that there was a case or controversy, the error could only have been reached by a bill of review or appeal and not by a delayed motion to vacate.[24]

Having been unsuccessful in attacking the validity of the consent decree, the packers now attempted, under a provision of the decree retaining jurisdiction of the cause for further proceedings, to show that a change of conditions in the food industry had occurred and that the continued enforcement of the decree was unjust to the packers and not necessary to the protection of the public. The instant suit was commenced in the Supreme Court of the District of Columbia in April, 1930, by petitions of Swift and Armour[25] to modify the decree insofar as it (1) restrains the packers from owning stockyards, market newspapers, terminal railroads, etc.,[26] and (2) restricts the use of their distributive facilities and restrains

22. The packers contended that the court had no jurisdiction to enter the decree as it was void for want of factual basis, that as no determination was made that defendants had violated the law, this being specifically denied by them, the court had no jurisdiction under the anti-trust laws to render a decree, that the decree was void in so far as it enjoined defendants from following lawful occupations in a lawful manner (*i.e.*, engaging in the unrelated lines), and that consent cannot confer jurisdiction beyond the legal power.

23. The Court of Appeals on January 3, 1927, dismissed the appeals for want of jurisdiction (in view of the Expediting Act, 32 STAT. 823, 36 STAT. 854 15 U. S. C. §§ 28, 29) upon the motion of the United States. On January 31, 1927, on motion of Swift and Armour the Court of Appeals vacated its order and restored the case for reargument upon the question of its jurisdiction of the appeals and for argument on its jurisdiction to transfer the appeal to the Supreme Court pursuant to § 238a of the Judicial Code (now repealed) allowing transfer to the proper court of an appeal taken to the wrong court. Thereafter the Court of Appeals certified to the U. S. Supreme Court questions of the jurisdiction of the Supreme Court of the District of Columbia and of its own jurisdiction. The U. S. Supreme Court, after hearing the argument on the certificate, ordered up the entire record and after holding that the Court of Appeals had no jurisdiction of the appeal decided the case as on transfer. *Infra*, note 24.

24. Swift & Co. v. U. S., 276 U. S. 311 (1928).

25. Cudahy and Wilson did not enter into the suit to modify the decree.

26. The packers had been unable to dispose of their interests in the stockyards and terminal railroads at what they considered to be a fair price. By a

the packers from entering or continuing [27] the unrelated lines and all forms of retail trade. The trial court refused to modify the restraints of part (1) [28] above, but finding that there no longer was any danger to the public welfare, removed the restrictions of part (2). The packers took no appeal from the court's decision with reference to (1). So, aside from the question of the jurisdiction of the court to modify the decree, the sole question before the U. S. Supreme Court [29] was whether the conditions of the meat packing business and the wholesale grocery trade had changed sufficiently since 1920 so that the danger of monopolistic control by the packers had been removed and, therefore, the exclusion of the packers as competitors in the general food industry had become injurious to the public and unjust to the packers.

A proper understanding of the problem before the Court requires an appreciation of the background of the packing industry and the methods of food distribution in the United States. Prior to the development of the refrigerator car there were no large fresh meat slaughterers. The high perishability of fresh meat necessitated slaughtering at or near the point of consumption. With the advent of the refrigerator car, however, animals were slaughtered near the centers of production and by shipping only the edible portions of the carcass, great savings in freight were obtained. Due to the large volume and centralization of the big packers, it became possible effectively to process the waste portions into salable by-products which is to a great extent impossible for the local slaughterer as his volume is insufficient to support the cost of the by-product processing plant. These two factors have encouraged the growth of the large packer and have caused the industry to become almost exclusively located at the large stockyards which in turn are located advantageously near the livestock producing centers.

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court order they had assigned all the voting stock in these companies to trustees appointed by the court, these trustees voting the stock. The trustees, however, left the management of the various stockyards to the management already in control as after a brief investigation they could find no unfair practices.

27. By various stays of execution of the decree, principally the order procured by the California Canneries suspending the decree, Swift and Armour were still engaged in the unrelated lines at the time of the last decision of the Supreme Court.

28. This makes it unnecessary to discuss that aspect of the business, except to note that when the PACKERS AND STOCKYARDS ACT, 42 STAT. 159 (1921), 15 U. S. C. § 181 (1926), placing the stockyards under public control and transferring to the Secretary of Agriculture jurisdiction over packers in respect of acts and practices violative of the anti-trust laws and competitive methods (the Federal Trade Commission would otherwise have jurisdiction of some of these matters), the prohibitions and regulations of the act were not made more stringent due to the prohibitions of the consent decree. Record p. 1056. It seems clear, however, that if the stockyards were carelessly supervised, control of the yards by the larger packers would be detrimental to the public interest. That the producers feel that the livestock industry is receiving little protection under the Packers and Stockyards Act, see 14 The Producer No. 2, p. 14 (1932).

29. U. S. v. Swift & Co., 286 U. S. 106 (May 1932).

Prior to 1920 the distribution of groceries to the public was almost exclusively handled by wholesalers purchasing from or acting as agents for manufacturers and producers, and distributing to independent retailers. Since then the importance of the wholesaler has been diminishing due to two factors: (1) the growth of the chain store, both regular and voluntary [30] (co-operative) and (2) the integration of food manufacturers who themselves perform the distributive function of the wholesaler.

The stipulations of the record in this case state that in 1920 there were in the United States approximately 15,000 regular chain grocery stores, and of that number approximately 1,200 had meat departments, while by 1929 this number had grown to 60,000 stores of which about 15,800 contained fresh meat departments.[31] The total annual sales of centrally owned grocery chain stores increased from $770,000,000 in 1920 to $3,500,000,000 in 1929.[32] The larger of these firms do a considerable share of the processing of meats they sell; they buy carcasses from the packers and then do their own curing, bacon slicing and sausage making. This is alleged by the packers to be the most profitable part of the packing operation. Testimony shows that there is about 35% of the retail grocery business in the hands of the centrally owned chains.[33] The voluntary chains are calculated to comprise almost 60,000 retail outlets, and, on the basis of a sample consisting of 36% of all voluntary chains, the number of units in 1929 is over four times that in 1920. Today approximately 60% of the total grocery business is concentrated in the hands of the regular and voluntary chains.[34]

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30. A regular chain is one in which there is one ownership and management of a chain of stores such as the Great Atlantic and Pacific Tea Co. The voluntary chain is a group of independently owned retailers who co-operate in joint buying, joint advertising, or in joint or group control of the operations of their retail stores. There are three groups or classifications of voluntary chains. The most important group is that which is sponsored by the wholesale grocers who obtain concentration of purchases from a group of retailers in return for merchandising and managing assistance which enables the retailers to operate their stores more efficiently. The second group, commonly called a retailer-owned wholesaler, is a regular wholesale grocery company having capital stock owned entirely or largely by retail grocers. The third consists of organizations in which a number of retail grocers combine for the purposes of group buying or group advertising but without ownership of wholesale grocery facilities.

31. Stipulations of parties, Record p. 567.

32. *Ibid.* Total grocery sales increased during this period but the largest part of the increase in grocery chain store sales came from business which was formerly handled by the independent grocers.

33. Record p. 519, Testimony of Victor H. Pelz, Director of Research Staff, American Institute of Food Distribution. The data of the Census of Distribution to be published in December, 1932, show that for the year 1929 the number of retail chain grocery units was 52,618 of which 17,249 contained fresh meat departments. Total sales of regular grocery chain stores were $2,833,980,000 which comprised 38.5% of total grocery sales.

34. *Supra* note 33. The witness admitted that this was only an estimate and based on a rather shaky foundation, but it is apparently the best obtainable figure. It seems reasonable as there are 120,000 chain stores out of a total of

The other important recent development in food distribution is the integration of manufacturers into large units and the formation of co-operative marketing associations by producers. Many formerly independent companies selling one or two branded commodities have merged into large corporations controlling several of these formerly independent manufacturers.[35]

The packers claim that these two developments have altered the system of food distribution so that they are in a greatly inferior position to that occupied by them in 1920. They say that chain stores are in a position to dictate prices to and to force large quantity discounts from the packers, and that, by their buying meat in carload lots from central packing points, the packers' branch house business is injured. These arguments, however, lose sight of the fact that the chains compete vigorously as buyers in the wholesale market, just as they compete as sellers in the retail market. The complaint of loss of the branch house business is of small importance. The packers are still selling their meat but the chains are buying directly in large quantities. It is probably true, however, through the changes in methods of food distribution, *i.e.*, the growth of the large retailer who is his own wholesaler, that the packers are losing that portion of their profit which would have been allocated to the operation of the branch houses.

The packers further contend that the public interest would be amply protected upon their entrance in the grocery lines by the competition which would be offered by the large food manufacturing companies. However, the competition of those amalgamated concerns which handle groceries would not be very extensive as their total volume of business is comparatively small[36] and the branded articles in which they deal do not constitute a very large share of the average grocery store volume. In urging that they be allowed to take on the prohibited lines, the packers point to the fact that these combinations represent a defense of small manufacturers against the pressure of chain store buying policies. But this integration of concerns in allied lines into "conglomerations," which was prevalent prior to 1929, was made with the view of securing more efficient distribution.[37]

The chief advantage the packers enjoy in distribution is through their ownership of almost all of the refrigerator cars suitable for transporting

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about 300,000 grocery stores and the business of a chain store unit is known to be much greater than that of the average independent.

35. General Foods Corporation, which grew out of the Postum Co., now manufactures and sells through its subsidiaries a great variety of branded articles. Standard Brands Inc. and Gold Dust Corporation are similar concerns. Large chains of dairies and ice-cream plants, such as National Dairy Products Corporation and the Borden Co., have sprung up, and in most of the larger cities they now practically control the milk and ice-cream business.

36. The sales of the four big food companies (National Biscuit Co., Standard Brands, Inc., General Foods Corp., Gold Dust Corp.) amount to but a fraction of the sales of either Swift or Armour.

37. Standard Brands' use of the Fleischmann delivery system for the distribution of its other lines is the best example.

meats.[38] A large part of these cars are used to ship carload lots to the branch houses, the remainder being used on "peddler"[39] car routes. By the tariff regulations of the railroads the freight charged on one of these cars is on a certain minimum weight, generally 100,000 pounds for the whole distance run by the car. Due to the necessity of maintaining a regular schedule it is very frequently necessary to send out a car with less than the minimum load for which freight is charged. If the packers were allowed to deal in groceries they could fill up the car with additional goods. For the amount added up to the minimum, under the mixing rules of the Interstate Commerce Commission,[40] there would be no additional charge. While the packers technically would pay freight for shipping the groceries they would pay practically the same amount for freight as if they had shipped only meats.[41] To this extent they would have an enormous advantage over the wholesale grocer who must pay freight on each item shipped. The refrigerator cars of the packers, due to the perishable nature of their contents, receive preferential handling from the railroads. By shipping groceries in these cars they would be able to make deliveries much more rapidly than the independent wholesaler who ships by regular freight service. This quick delivery of the packers' shipping system would give them a considerable trading advantage due to the increasing tendency of retailers to buy from hand to mouth.

The packers also would be able to utilize their branch houses as warehouses for groceries and the same salesmen could take orders for both meats and groceries. The packers are thus in a position to distribute "substitute" foods (*e. g.*, eggs, fish and other substitutes for meats) and other unrelated commodities with slight increase in overhead, the practical effect of which would be to make the packers' profit on the grocery line closely approach the gross margin of selling price above cost.[42]

38. A distinction should be made between a meat car and one for vegetables or fruits. Meats are required to be kept at a temperature of 30-32° F. while vegetables and fruits take a temperature of about 40° F. It is possible to obtain the latter temperature with the ordinary ventilator refrigerator car which has bins in each end which are filled with ice. The meat car on the other hand is air-tight and to produce a sufficiently low temperature ice and salt are placed in brine tanks. The cars must be made with a stronger roof as the carcasses are suspended from the roof of the car. The big packers own about 90% of the meat cars, the rest being owned by the independents and a few by common carrier car lines.

39. A peddler or route car is a refrigerator car which is sent out from a packing plant or a branch house, operating on a regular schedule and serving towns too small to support a branch house.

40. See National Wholesale Grocers Association v. Director General, 62 I. C. C. 375 (1921).

41. The statement that the "meat carries the load," *i.e.*, the freight, is obviously inexact. But the packer can make a profit on his meat by shipping it alone, so when he adds groceries to his car and is forced to pay no more his position as regards competition with the grocer is the same as if he paid no freight.

42. Subject of course to a qualification similar to that in note 41—that no apportionment of the existing overhead be made.

It would thus seem that the price to the public of all food would tend to be reduced.

The opinion of the Court summarily disposed of the packers' contention that they should be allowed to recoup the alleged profits lost by the chain store buying policies by entering the wholesale grocery business and that such entrance is in the public interest. Mr. Justice Cardozo pointed out that, although the packers' capacity to make such distribution cheaply by reason of their existing facilities was one of the principal reasons why the decree was modified in the lower court, it was one of the chief reasons for excluding the packers from the unrelated lines in the original decree. He also emphasized the fact that the packers had been guilty of numerous aggressions throughout their history, and that the fear of a recurrence of such aggressions, which had been a moving cause for the injunction of 1920, had not been removed. Furthermore, the danger that the packers, if permitted to deal in groceries, would drive their rivals to the wall, still existed. The Court, showing a fear of "full line forcing" by the packers, dismissed the rise of the chain stores with the declaration that the chains now look to the packers for their meats[43] and, with the modified decree, would naturally look to them for other things as well. The order modifying the decree on the ground that conditions had not changed sufficiently to make the restraints unduly oppressive was therefore reversed.[44] The final decree on the mandate was issued in the Supreme Court of the District of Columbia on June 15, 1932, giving the packers one year from the date to dispose of their stocks on hand. It is believed that this is the last word in the case, the decree having been sustained upon every ground.

As the report of the Federal Trade Commission led to the suit, it is interesting to consider its position when asked to report on the proposed vacation of the decree in 1924.[45] After its original investigation, the Commission had recommended to the President that the packers be required to give up their control over the stockyards and the refrigerator car lines and that the Government take over control of such of the branch houses, cold storage plants and warehouses of the packers as were necessary to provide facilities for the competitive marketing and storage of food products in the principal centers of distribution and consumption.[46] The

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43. Sales of the big four in 1929 were $2,500,000,000; those of their thirteen principal competitors were $407,000,000.

44. Brandeis, McReynolds, and Roberts, JJ., concurred; Butler and Van Devanter, JJ., dissented, finding that conditions had changed sufficiently to make continued enforcement of the decree inequitable to the packers; the Chief Justice, Mr. Justice Sutherland and Mr. Justice Stone took no part in the consideration of this case. The Chief Justice had appeared as counsel for the packers in this suit, Mr. Justice Stone had been Attorney General while the suit was pending, and Mr. Justice Sutherland had been a trustee of the court holding the stock of the packers in the stockyards companies until the packers could dispose of it.

45. F. T. C. REPORT ON PACKER CONSENT DECREE, SEN. DOC. No. 219, 68th Cong. 2d. Sess. (1925).

46. *Supra* note 11, Part I, at 26.

Commission's report on the consent decree stated that the Commission had not been consulted as to its terms and found fault with it on the ground that the packers had been allowed to retain their refrigerator car lines. The Commission attached little importance to the whole question of packer manufacture or sale of the unrelated lines once the big packers were divorced from their control of refrigerator cars.[47] "In so far as this (packers' refrigerator car) system offers economies and better services it should be preserved, if practicable. But if it involves a menace to competition in the sale of grocery products, or an unfair advantage to one group of competitors it should be regulated to avoid those evils. Through divorcement of the packers from their control of refrigerator cars, thus rendering their car service available on equal terms to all distributors of meats and groceries, the Commission believes that the alleged economic advantages of the system to the public may be preserved and the competitive disadvantages to other distributors eliminated."[48]

It seems that the idea of eliminating the packers from the unrelated lines originated with Mr. Hoover when, as Food Administrator, he was asked to submit his conclusions on the recommendations of the Federal Trade Commission.[49] Mr. Hoover agreed with all the recommendations of the Trade Commission except as to public control of the branch houses, etc.,[50] and brought up the question, which had not been discussed in the Commission's recommendations,[51] of the whole phase of absorption of other food industries. He found it "at least worth thought" whether the packer aggregations should not be confined to more narrow and limited activities such as those involved in the slaughter of animals, the preparation and marketing of the products therefrom alone.

The economic considerations pertinent to a decision upon modification of the consent decree may be summarized as follows:

(1) Whether the packers, if left unrestricted and allowed to expand into every line of food distribution until they become a major influence

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47. The position of the Commission would not provide a cure of the alleged evils existing as a result of the big packers' advantages in transportation. It would offer refrigerator car service to all shippers on an equal basis but the advantage of speedy shipment would still obtain in the competition between the packers and the grocery wholesalers as refrigerator cars are a specially expedited form of traffic.

48. *Supra* note 11, Part I, at 31-32. In the next paragraph it is stated, qualifying the above, that the Commission prefers not to express an opinion on the economic wisdom of permitting the big packers to resume the distribution of groceries or other unrelated lines without a comprehensive study, an important part of which would be an inquiry into the extent to which competition has been restored in the meat packing industry.

49. Letter of Mr. Herbert Hoover, Food Administrator, to the President, Sept. 11, 1918.

50. He disagreed with this recommendation on the ground of its practicability only.

51. The distinction should be made between the recommendations of the Trade Commission made in a letter to the President on July 3, 1918 and the report which was issued at intervals from November 1918 to June 1919.

in each line, will still be able to offer cheaper distribution and handling. Mr. Hoover said: "It is certain to my mind, that these businesses have been economically efficient in their period of competitive upgrowth, but as time goes on, this efficiency cannot fail to diminish and, like all monopolies, begin to defend itself by repression rather than by efficiency." That the packers perhaps have reached this point of diminishing returns might be indicated by their earnings as compared with those of the independent packers.[52]

(2) Whether it follows that the claimed economies of large scale packer distribution of groceries will be passed on to the consumer, especially in view of the previous commercial practices of the packers.

(3) Whether, even if these economies are effected and part of the saving is passed on to the consumer, other social considerations such as (a) preservation of the competitive system and (b) prevention of concentration of control of the food industry in a few hands,[53] are sufficient to warrant continuance of the restrictions.

In spite of the fact that some of the justices of the Supreme Court are reputed to be quite skeptical of the competitive system, the opinion of the Court seems to be mainly based on the ground that modification would tend to destroy that system insofar as the food industry is concerned. Once

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52. *Supra* note 49. The percentage earnings on net worth of all meat packing companies reporting to the Packers and Stockyards Administration in 1929 was 6.45%, that of the big packers was 4.55%, defendants' brief pp. 52-53, Record pp. 817, 888a. On the other hand the lower earnings of the big packers might be ascribed to the fact that they are engaged in many lines of activity in which profits are always low and that this brings down their average profit percentage on all their business. No figures are available to compare earnings solely from the meat packing industry of the big packers and those of the independents.

53. It is apparent that such a large unit would in innumerable ways be able to dictate to trade generally and to secure great advantages to the general detriment and suffocation of competition. Timely examples are the various "tonnage reciprocity" arrangements which would force the railroads into making what is in fact a renewal of the rebate system. Swift and Armour have both been able to engage in this practice. The Mechanical Manufacturing Co. owned by members of the Swift family and officers of Swift & Co. manufactures bumping posts, draft gears and other railway equipment. The Waugh Equipment Co. similarly owned by the Armour people produces draft gears, centering devices and other railway appliances. Suggestions were made to the traffic department of a railroad that the Swift or Armour people respectively would be very pleased if that railroad would be able to utilize any of the products of that company. Obviously, the railroad which buys the equipment obtains the traffic of the packers which is largely competitive as to routings. Cease and desists orders were issued against both concerns by the Federal Trade Commission. In the Matter of Waugh Equipment Co., 15 F. T. C. 232 (1931); In the Matter of Mechanical Manufacturing Co., F. T. C. Doc. 1727, decided March 4, 1932. The Interstate Commerce Commission has conducted an exhaustive inquiry into the general subject of tonnage reciprocity but as yet has announced no conclusions.

convinced that such a large share of the industry should not be controlled by one or two interests, the court was compelled to refuse modification since otherwise it would be impossible ever again to enjoin the packers from lawfully engaging in the now prohibited unrelated lines.

STATE TAXATION OF ELECTRIC POWER

A SUGGESTED MODIFICATION OF COE V. ERROL

IT is generally conceded that the true function of constitutional doctrines is to serve as a means of rationalizing decisions for purposes of clarity and predictability.[1] Where, because of changing social conditions, individual doctrines no longer serve their function, it is time that they should undergo a process of restatement in harmony with the Supreme Court's prevalent notions of social policy.[2] Several recent cases of taxation under the commerce clause of the Constitution[3] would seem to indicate that at least one constitutional doctrine which has done yeoman's service for close to half a century is ready, if not past due, for such a process of change.

In the year 1885 the case of *Coe v. Errol*[4] came before the Supreme Court. New Hampshire logs had been hauled to the banks of the Androscoggin River and there piled awaiting spring freshets to carry them downstream to a point in the state of Maine. New Hampshire tax day arrived while the logs were on the river bank. Balancing the social need for free channels of commerce against New Hampshire's need for revenue, the Court did not hesitate to sustain the property tax, announcing in its opinion that goods do not begin to be governed and protected by the national law of commercial regulation until the moment "in which they commence their final movement for transportation from the State of their origin to that of their destination,"[5] and that the hauling to the river banks was merely preliminary to such final movement. Thus arose the doctrine that goods enter interstate commerce at the moment in which their final movement to an extra-state destination commences.

Early in the career of *Coe v. Errol* the Court had occasion to enunciate a supplementary doctrine. In *Kidd v. Pearson*,[6] a case involving the validity of an Iowa statute prohibiting the manufacture of intoxicating liquor within the state, the Court stated that as manufacture is not a part of interstate commerce, prohibition of manufacture is not a burden thereon. Seven

1. Albertsworth, *The Rise and Fall of Constitutional Doctrine* (1931) 17 A. B. A. J. 471, 472.
2. *Id.* at 471 *et seq.*
3. U. S. Constitution, Art. I, Sec. 8, Clause 3.
4. 116 U. S. 517 (1886).
5. *Id.* at 525.
6. 128 U. S. 1 (1888).

years later, in *United States v. E. C. Knight Co.*,[7] a case involving the federal anti-trust laws, the principle of *Kidd v. Pearson* was expressed in the oft-quoted statement that "commerce succeeds to manufacture and is not a part of it." Though this doctrine has been questioned, in taxation cases at least, it has lived a hardy life. So long as processes of manufacture and production continued to be such that they were entirely completed before the final movement of commodities to their destination had commenced, there was no doubt that the doctrines of *Coe v. Errol* and *Kidd v. Pearson* were in absolute harmony with one another. As processes of manufacture and distribution became integrated, however, it became increasingly difficult to maintain this harmony. Recent litigation would seem to indicate that it is now impossible so to do.

In *Oliver Iron Mining Co. v. Lord*,[8] decided in 1923, the subject or attack was a Minnesota occupation tax on all ore mined within the state. In the case of several of the appellants, the act of mining consisted in steam shovels severing the ore from its natural bed and dumping it into cars which were immediately hauled away and formed into trains which started the ore on its interstate journey. From the instant of severance there was a continuity of movement, on which was predicated the claim of the appellants that the tax constituted an unconstitutional burden on interstate commerce. The Court found, however, that the act of severing the ore was an act of production preceding final movement, and as such subject to state taxation.

Assuming that the doctrines of *Coe v. Errol* and *Kidd v. Pearson* have actual worth as instruments of forecast, there would have been no great difficulty in predicting the outcome in *Oliver Iron Mining Co. v. Lord.* However, prediction of the next important case to come before the Court would have proven more difficult. In *Hope Natural Gas Co. v. Hall*,[9] the state of West Virginia had imposed an occupation tax measured by the gross proceeds from the sale of natural gas produced within the state. The appellant conceded that under the rule of the preceding case a tax on the gas at the well would be valid, but assailed the tax as to gas pumped outside the state in continuous movement from the wells as being imposed upon the gross proceeds of sales in interstate commerce.[10] The Supreme Court held, however, that the tax, as construed by the state court to be upon the value of the gas at the wells before interstate commerce had commenced, was valid. It is difficult to see how the statute could be so construed. The sole act of production in the case of natural gas is the act of pumping, or, if under natural pressure, the opening of valves. This act is the production of the final, continuous movement of the gas in its interstate journey.[11] Until this movement is started there is no act of

7. 156 U. S. 1 (1895).

8. 262 U. S. 172 (1923).

9. 274 U. S. 284 (1927).

10. Under the rule of Philadelphia & S. Mail S. S. Co. v. Pennsylvania, 122 U. S. 326 (1887), and cases following it.

11. Of course, the Court might have done lip service to the doctrine of Coe v. Errol by fixing some arbitrary point in the continuous flow of gas, e. g., at the pumps, and saying that up to that point the flow was "merely preliminary."

production subject to taxation. The tax was an occupation tax rather than a property tax, and could not be assessed before the act of production had occurred. That act was, under any reasonable application of *Coe v. Errol*, an act of interstate commerce, and immune from state taxation. But the decision was otherwise.

The doctrine of *Coe v. Errol* was even more inadequate for the purpose of predicting the result reached, in the recently decided case of *Utah Power and Light Co. v. Pfost.*[12] The state of Idaho had imposed an excise tax of one half mill per kilowatt hour on all electric energy generated within the state "either through water power or by any other means" for barter, sale, or exchange. The appellant was engaged in the generation of electric energy by the use of water power. Approximately 85% of the energy so generated was transmitted to and sold in Utah and Wyoming.[13] The appellant's major contention was that as to this portion of the energy generated, the appellant was engaged in interstate commerce, and was thereby exempt from state taxation.

Despite the general consensus of scientific opinion to the contrary,[14] the Court, speaking through Mr. Justice Sutherland, declared that "it is wholly inaccurate to say that appellant's entire system is purely a transferring device," and stated that "on the contrary, the generator and the transmission lines perform different functions, with a result comparable, so far as the question here under consideration is concerned, to the manufacture of physical articles of trade and their subsequent shipment and transportation in commerce."[15] If the scientific view that an entire electric system is nothing more than a device for the transfer of energy[16] be accepted for legal purposes, a generator in an interstate power system is nothing more than an intermediate carrier of the intangible commodity energy. As the final continuous movement of energy commences, in the case of a hydroelectric system, at the instant when the water begins to flow through the flume at the dam, and is not interrupted until the point of utilization is

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12. 286 U. S. 165 (1932). The earlier stages of the case are reported in 54 F. (2d) 803 (D. Idaho 1931), and 52 F. (2d) 226 (D. Idaho 1931).

13. This percentage is not given in the opinion of the Supreme Court, but can be derived from figures reported in 54 F. (2d) 803, 804 (D. Idaho 1931).

14. See, for example, the affidavit of Dr. Robert A. Millikan, reported in the related case of South Carolina Power Co. v. South Carolina Tax Commission, 52 F. (2d) 515, 523 (E. D. S. C. 1931). Dr. Millikan gave similar testimony in the Utah Power Co. case (Record, pp. 109-122), as did Dr. Irving Langmuir, Assistant Director of General Electric Company's research laboratory (Record, pp. 122-142).

15. Utah Power and Light Co. v. Pfost, 286 U. S. 165, 180-181 (1932).

16. The so-called "forms of energy," such as electric energy, mechanical energy, etc., get their names from the various carriers of energy. Energy itself is intangible and incapable of form. Because of its incapability to take form, and of its constant nature regardless of the change in carriers, it is not surprising that the Court was unwilling to accept energy apart from some particular carrier as a new commodity of commerce.

reached,[17] under the doctrine of *Coe v. Errol* the act of generation, being but an act of transmission subsequent to the commencement of this final movement, would clearly be an act of interstate commerce.

Even though we accept as justified the Court's refusal to recognize energy apart from form as a commodity of interstate commerce and consider that the generator, in changing the form of energy from mechanical to electrical, engages in an act comparable to manufacture or production, the doctrine of *Coe v. Errol* if applied would lead to a decision contrary to that reached by the Court. The transformation of energy to electric form, which constitutes the sole act of production, consists of the production of a current or flow of electrons under pressure.[18] Without electric pressure there can be no electric current, and without the simultaneous occurrence of electric pressure and electric current, there can be no production of electric energy.[19] Hence it may be said that electric energy is created[20] simultaneously with electric current. But from the very moment that electric current is created, electric energy is transmitted at the phenomenal rate of 186,000 miles per second.[21] Thus electric energy is created, or rather, energy is transformed to the electric form, while enroute to its final destination at that rate of speed.[22] Therefore, despite Mr. Justice Sutherland's *ipse dixit* statement that "while conversion and transmission are substantially instantaneous, they are, we are convinced, essentially separable and distinct operations,"[23] it is impossible to assess the Idaho tax before the final interstate movement of electric energy commences.[24]

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17. See the evidence cited *supra* note 14. The lower court included this statement in its findings of fact (Record, p. 90).

18. See the evidence cited *supra* note 14; also 8 ENCYCLOPAEDIA BRITANNICA (14th ed. 1929) 174 *et seq.*

19. *Ibid.*

20. It is fundamental that energy itself cannot be created or destroyed. By the creation of a particular form of energy is meant its transformation from a like amount of energy in some other form.

21. See the evidence cited *supra* note 14.

22. The very fact that it is physically impossible to store electric current or energy in an alternating current system such as all interstate power companies employ (see the evidence cited *supra* note 14) necessitates that the transmission be continuous. An electric transmission system does not even have storage capacity such as that in a natural gas pipe line, since a flow of electrons, unlike a flow of gas, is practically incompressible.

23. Utah Power and Light Co. v. Pfost, 286 U. S. 165, 179 (1932).

24. In the related case of South Carolina Power Co. v. South Carolina Tax Commission, 52 F (2d) 515, 524 (E. D. S. C. 1931), *aff'd,* 286 U. S. 525 (1932), the District Court, somewhat in the manner suggested *supra* note 11, stated that the interstate movement of electric energy did not commence until after the energy had passed through the step-up transformers prior to long distance transmission. Inasmuch as the quantity of electric energy would be substantially the same and since there would be no interruption whatsoever in its 186,000 miles per second transmission up to, through and beyond the transformers, even though the characteristics of the carrier (viz. current and pressure of the flow of electrons) would be changed, it is rather difficult to consider the energy leav-

The conclusion to be drawn from the decision of the Court in the *Utah Power Company* case as interpreted in the light of the facts as they are, rather than as Mr. Justice Sutherland concluded them to be, is that a commodity does not always enter interstate commerce at the moment in which its final continuous movement to an extra-state destination commences. Instead, a commodity does not enter interstate commerce, regardless of when such final movement commences, until manufacture or production has been completed. It would seem then that in order to avert a recurrence of litigation such as has taken place in the three recent cases discussed,[25] the Supreme Court should discontinue its efforts to separate production and distribution into severable and distinct transactions regardless of the physical facts involved, and enunciate instead the doctrine that irrespective of when distribution is begun, production or manufacture for extra-state distribution is not an act of interstate commerce. In other words, wherever on the physical facts of a case *Coe v. Errol* and *Kidd v. Pearson* are in conflict, the doctrine of *Kidd v. Pearson* is to control.

Any effort to modify constitutional doctrine to conform to current decisions necessarily focuses attention on the question of the value of the proposed modification. Assuming that prior to the case of *Oliver Iron Mining Co. v. Lord,* the first of our three recent cases in point of time, the Supreme Court had enunciated the doctrine suggested above, to the effect that in any case of conflict between the principles of *Coe v. Errol* and *Kidd v. Pearson* the doctrine of the latter case should reign supreme, would the expensive litigation in those cases have been avoided?

It seems evident from a consideration of the decisions themselves, though not from the opinions,[26] that the motivating cause behind each decision was the Court's contemporary notions of social policy. Undoubtedly the pressing need of the states for additional sources of revenue to meet mounting costs of government was a powerful factor behind each decision.[27] In the first two cases, exhaustion of the state's natural resources was another consideration in the state's favor; but in the last case, since the tax was not restricted to hydro-electric plants, the exploitation of natural

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ing the transformer as a new commodity or the transmission up to the point of leaving the transformer as "merely preliminary." It is interesting to note that though the lower court in Utah Power and Light Co. v. Pfost, 54 F (2d) 803, 805, 806 (D. Idaho 1931), placed some reliance on the holding of the District Court in the South Carolina case, the Supreme Court did not resort to that argument.

25. See notes 8, 9 and 12, *supra.*

26. Opinions such as those in these three cases have given rise to the statement that "what is being taxed seems sometimes to be determined by norms of nomenclature rather than economic effect;" Powell, *State Production Taxes and the Commerce Clause* (1923) 12 CALIF. L. REV. 17.

27. That past decisions have seriously handicapped the states, see Albertsworth, *Congressional Assent to State Taxation Otherwise Unconstitutional* (1931) 17 A. B. A. J. 821.

resources was not, on the record at least,[28] an element. On the other hand, in each of the three cases the business of the appellant clearly transcended state lines. Furthermore, in each case the state appeared to be taking advantage of the unequal distribution of natural resources to exact a toll on commodities flowing out of the state.[29] In view of the fact that the Supreme Court has recently declared that under certain circumstances a state may not directly[30] or indirectly[31] forbid the exportation of its natural resources or require their reduction to the finished product within the state,[32] this aspect of a toll on exports would seem to weigh somewhat against the states. Perhaps in the *Natural Gas* case, certainly in the *Utah Power Company* case, a factor for consideration was the possible advantage of reserving generation, or production of interstate power, or gas, for federal or regional regulation as a single unit along with transmission and sale to distributing companies, which the states have already been denied the power to regulate.[33] Against this, however, would weigh the necessity of letting the utilities proceed unregulated and untaxed until such regional or federal boards should be established, and also the possibility of recognizing power in the states only until such boards should be established.

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28. Though the fact was not brought out in the record, practically all power developed within the state is developed from water power. The 1926 figures for electric power production within the state by public-utilities showed 808,522,000 kilowatt-hours from water power and 2,267,000 kilowatt-hours from other sources; U. S. Geological Survey, Water Supply Paper No. 579 (1928) pp. 164-166.

29. In the Oliver Iron Mining Company case, practically all of the ore was destined for points outside the state. In the Hope Natural Gas Company case, figures given in Pennsylvania v. West Virginia, 262 U. S. 553, 589 (1923) would seem to indicate that nearly 60% of the gas produced within the state is shipped outside the state. In the Utah Power Company case, assuming total production by utilities within the state in 1930 equal to the 1926 figures of 810,789,000 kilowatt-hours, *supra* note 28, in 1930 the appellant alone transmitted 198,502,000 kilowatt-hours, *supra* note 13, or more than 24% of the total for the entire state for the year, to points outside the state. Figures for other companies are not now available. Idaho has only 12% of the population of the eight Mountain states; but 26% of the potential water power available 50% of the time and 31% of the installed water power; U. S. Geological Survey, *op. cit. supra* note 28, at 123-128.

30. Pennsylvania v. West Virginia, 262 U. S. 553 (1923).

31. Oklahoma v. Kansas Natural Gas Co., 221 U. S. 229 (1911).

32. Foster Packing Co. v. Haydel, 278 U. S. 1 (1928).

33. Missouri v. Kansas Natural Gas Co., 265 U. S. 298 (1924); Public Utilities Commission v. Attleboro S. & E. Co., 273 U. S. 83 (1927). See note (1931) 41 YALE L. J. 305. The problem as to when electric energy leaves interstate commerce is quite as intricate as the problem as to when it enters it. With Public Utilities Commission v. Attleboro S. & E. Co., 273 U. S. 83 (1927), where a sale to a distributing company of electric energy transmitted across a state line was held to be an act of interstate commerce, compare South Carolina Power Company v. South Carolina Tax Commission, U. S. Daily, July 26, 1932, at 982, (E. D. S. C. 1932), where such a sale at high voltage was held

With these and like considerations as the true circumstances controlling decisions, it might be asked how the proposed modified doctrine would offer any improvement over the rule of *Coe v. Errol.* Under either of these doctrines, the sole test of constitutionality would be: when is the tax assessed? But clearly it is hardly more important in deciding cases involving state taxation to determine when the burden is imposed, than it is to determine whether the burden itself is slight or excessive; whether, as compared to expected benefits to, or the needs of, the taxing state, it is unduly heavy; and whether the prognosticable repercussions of a particular decision will be desirable or undesirable. Notwithstanding all this, however, the proposed doctrine would seem to have distinct merit.

Perhaps sufficient justification for the retention of technical doctrines lies in the fact that thus far no workable doctrine bearing a logical relation to the more important considerations has been developed. Until the stage is set for some such radical change as the exclusive allocation of all businesses transcending state lines to the federal government, with a single uniform system of taxation and apportionment[34] of revenue to the several states to meet their fiscal needs, it would seem that technical doctrines based upon physical distinctions are the best that can be devised. But it is essential that such doctrines, in order to avert unnecessary and illogical litigation based upon minor issues, must be so modified and modernized that the same results may be reached in the decision of cases by a consideration of all the circumstances involved as by the application of the pertinent technical doctrines to the physical facts of the cases.

It is in compensating for a change in the physical facts of production and distribution, where there has seemingly been no change in the direction of the resultant of all material factors, that the merit of the proposed modified doctrine lies. Had the rule been existent before our three recent cases were litigated, it does not necessarily follow that there would have been no litigation,[35] but it does follow that the distinction from other

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not to be an act of interstate commerce because made from the same distributing line from which local retail sales were made after reduction of voltage.

34. That apportionment is suggested as a present need, see Albertsworth, *supra* note 27.

35. State occupation taxes are frequently attacked on grounds other than that of constituting a burden on interstate commerce. Furthermore, the claim that an occupation tax is a burden on interstate commerce may be based on the contention either that it is imposed upon an act or article of such commerce or that it is measured by value derived from such commerce. The latter argument was advanced in the Hope Natural Gas Company case, *supra* note 9. Had the state court not held that the tax was to be measured by the value at the wells, the Supreme Court would have had to determine whether the sales value and the value of the gas prior to the commencement of interstate commerce were the same, in which case measurement by sales in interstate commerce would be nothing more than a convenient method of measuring the production tax, under American Manufacturing Co. v. St. Louis, 250 U. S. 459 (1919). The fact that technical doctrines take into account only one factor behind decisions necessitates not only that doctrines be constantly revised but also that they be numerous and flexible.

earlier cases in which production taxes had been upheld, could not have been made on the basis of a change in the time of production relative to the time of commencement of final movement. In like manner, the same issue could not arise as to subsequent taxation of production in highly integrated modern industries. Thus there would be prevented the accentuation of a minor issue which might occur so long as the doctrine of *Coe v. Errol* remains unmodified. Furthermore, clarity of decisions would be preserved by elimination of the necessity of distorting physical facts, as in the *Utah Power Company* case, in order to explain desired results by the application of outworn technical doctrine. Moreover, so long as there is no change in direction of the resultant of all material factors influencing the validity of state occupation taxes, some basis of predictability would be afforded.

STATUTORY TREATMENT OF ANCESTRAL ESTATE AND THE HALF BLOOD IN INTESTATE SUCCESSION

THE modern tendency toward statutory simplification of the law of intestate succession seems obviously desirable, and convenience of administration is a particularly persuasive factor in dealing with a problem the solution of which is not convincingly explicable in terms of justice to the parties involved. While the statutory scheme of intestate succession should, of course, provide for results that in general seem fair, it can hardly be framed so as to meet the exigencies of particular situations without setting up a machinery of unwarranted complexity. The owner's almost unlimited power of escaping the effects of the scheme by *inter vivos* or testamentary disposition must be relied upon as a means of adjustment to particular circumstances. Some statutory preferences, such as that of lineal descendants, probably meet with general approval in view of the usual social and economic relationship between the preferred class and the intestate; and any change in them might well be resisted. In other instances, however, consideration of the equities of specific cases being precluded, it seems impossible to predict with any accuracy which of various alternatives will in the long run provide the most satisfactory distribution. This would seem to be true of the related questions of ancestral estate and inheritance by relatives of the half blood.

The "ancestral estate" doctrine originated in the common law rule of descent that only those collaterals who were of the blood of the "first purchaser" of the land could inherit; those not of his blood were entirely excluded—the land would escheat rather than go to them. Thus, if a father purchased land which thereafter passed by descent to his son, and the son then died intestate without issue, only those collaterals who were related by blood to the father could inherit the land from the son; collaterals on his mother's side were excluded from inheriting it. Or, if his mother were the purchaser, his father's relatives would be excluded (unless, of course, they were related by blood to the mother in some other way and not merely by marriage). Or, if his father's mother were the purchaser his father's father's brother would be excluded. If the intestate himself were the purchaser, this rule would have no effect; only his blood relatives would be heirs in any event at common law. In other words, the common law of descent inquired into the source of the intestate's title in order to return the land, in the event of failure of lineal descendants, to the relatives of the person who first brought it into the family. No such doctrine as this appears to have obtained in the distribution of intestate personalty in England. Blackstone attempted to trace the common law rule to a purely feudal origin,[1] but modern historians tend to discount the effect of feudalism, and believe that the doctrine was probably more ancient and widespread.[2] The conception that property should return to the side of the family from which it came is reasonable enough. On the other hand, complete abolition of the doctrine is not likely to meet with serious opposition and has the definite administrative advantage of eliminating from the intestate scheme a complex product of obscure antiquities.[3]

Under the common law of descent, kindred of the half blood (*i.e.*, collateral relatives of the intestate descended from different spouses of a common ancestor) were absolutely excluded. The land would escheat if only relatives of the half blood survived. In the case of personalty, however, the Statute of Distributions of 1670 was construed to permit relatives of the half blood to share equally with those of the whole blood of the same degree. Blackstone explained the common law exclusion of the half blood as a rule of evidence auxiliary to the requirement that the heir be of the blood of the first purchaser.[4] But this seems an unconvincing basis for the doctrine,[5]

1. 2 BL. COMM. *220. His fundamental suggested reason for the origin of the rule was apparently that aptitude for the performance of feudal services would run in the blood. The "first purchaser" would be the original tenant selected by the lord for the performance of these services, and only those of his blood should be permitted to take his place in the feudal relationship.

2. 2 POLLOCK & MAITLAND, HISTORY OF ENGLISH LAW (2d ed. 1898) 300; 2 HOLDSWORTH, HISTORY OF ENGLISH LAW (3d ed. 1927) 93; 3 id. 179. *Cf.* MAITLAND, *The Law of Real Property* (1879), 1 COLL. PAP. (1911) 162, 175 ("'Feudalism' is a good word, and will cover a multitude of ignorances.")

3. Simes, *Ancestral and Non-ancestral Realty*, (1928) 2 U. CINN. L. REV. 387. For means of breaking descent, see (1912) 12 COL. L. REV. 625.

4. 2 BL. COMM. *228. The basis of this rationalization is that, since a relative of the half blood would have fewer ancestors in common with the intestate than a relative of the whole blood, the former would be less likely than the latter to be of the blood of the first purchaser. *Cf.* 3 HOLDSWORTH, *op. cit. supra* note 2, at 183.

5. The argument that relatives of the half blood were entirely excluded in all cases because of the possibility that in some cases they might not be of the blood of the first purchaser is not persuasive. In many situations, a relative of the half blood might be related to the first purchaser whereas a relative of the whole blood would not. This was not a matter of a presumption; the half blood would be excluded even if definitely proved to be of the blood of the first purchaser. To explain an inflexible rule of total exclusion

and surely would not justify its continuance today. The exclusion of the half blood was only decided upon after a period of fluctuation and uncertainty as to the proper disposition of the matter. There seems no obvious solution of the problem. The common law rule, though arbitrary, was clear and simple and increased the possibility of escheat; perhaps no more complex explanation is justified.[6] Total exclusion of the half-blood, however, would seem unnecessarily severe today, though the diversity of the American statutes indicates that there is little uniformity of opinion as to their proper place in the intestate scheme. Attempts to argue either this matter or that of ancestral estate in terms of the probable intention of the deceased seem too speculative to be useful.[7]

A majority of the United States no longer recognize the doctrine of ancestral estate, but distribute realty and personalty without regard to the source of the intestate's title.[8] Those states still retaining a semblance of the doctrine have modified the common law by statute.[9] The ancestor from whom descent must be traced is, with the exception of North Carolina,[10] the one from whom the property immediately came to the intestate, rather than the first or original purchaser.[11] The term "ancestor" is not confined to a progenitor, but includes any blood relation.[12] Whether, at common law, "first purchaser" included other than lineal ascendants is problematical.[13] Under modern statutes, a child may for this purpose be the ancestor of its parent.[14] In Indiana, a husband has been held to be

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of intestate successors in terms of a rule of evidence would be unsatisfactory in any event, and is particularly so here in view of its slight and fortuitous probative value. Blackstone himself demonstrated the defective character of this apologia, and suggested alteration of the rule.

6. 2 POLLOCK & MAITLAND, *op. cit. supra* note 2, at 305.

7. Ascertainment of the supposed intention of the transferor in the construction of a written instrument of transfer is problematical enough. Yet such a case at least concerns a particular individual, and the language of the instrument and other admissible evidence furnish some data.

8. Six states exclude the whole blood as well as the half blood. ARK. STAT. (Crawford & Moses, 1921) §§ 3480, 3482; IND. GEN. STAT. (Burns, 1926) §§ 3329, 3330; N. J. COMP. STAT. (Cum. Supp. 1925) § 57 (5) (6); N. C. ANN. CODE (1931) § 1654 (4) (6); R. I. GEN. LAWS (1923) § 5551; TENN. CODE (Shannon, 1932) § 8380. See note 23 for modification of North Carolina Statute.

9. See *supra*, note 8 and statutes cited in notes following.

10. Poisson v. Pettaway, 159 N. C. 650, 75 S. E. 930 (1912).

11. Daly v. Connolly, 159 Atl. 314 (N. J. 1932) (mother); Lincoln v. Herndon, 141 Okla. 212, 285 Pac. 120 (1930); Note (1916) L. R. A. 1916 C 902, 914 *et seq.*

12. Purcell v. Sewell, 134 So. 476 (Ala. 1931) (aunt); Bailey v. Bailey, 25 Mich. 185, 188 (1872); Brower v. Hunt, 18 Ohio St. 311, 338 (1868).

13. The common law authorities neglect to discuss this question. See 2 POLLOCK & MAITLAND, *supra* note 2, at 300; 2 BLACKSTONE, COMM.* 220; *cf.* McCarthy v. Marsh, 5 N. Y. 265, 282 (1851).

14. Lavery v. Egan, 143 Mass. 389, 391, 9 N. E. 747, 749 (1887).

the ancestor of his surviving spouse.[15] Such results would be impossible at common law because of the incapability of inheritance of a lineal ascendant or surviving spouse. Another deviation from the common law lies in the inclusion within the doctrine of realty coming to the intestate by devise or gift as well as by descent.[16] Rhode Island expressly limits the application of its ancestral estate statute to realty only.[17] The majority of states no longer differentiate between realty and personalty in the distribution of intestate property.[18] In the absence of express limitation the ancestral estate statutes might well be applied to both realty and personalty. Several early cases, however, have confined the doctrine of ancestral estate to realty, both because of the administrative difficulty of identifying the source of changeable and transitory chattels and by reason of the historical basis of the doctrine.[19]

Modern statutes governing ancestral estate merge that doctrine and inheritance by the half blood. The modified expression of the doctrine now usually operates only to exclude kindred of the half blood. The treatment of the half blood in this country is very diverse. In thirteen states distributing realty and personalty without regard to the source of the intestate's title, kindred of the half blood take equally with those of the whole blood of the same degree of consanguinity.[20] Thirteen states[21]

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15. Cornett v. Hough, 136 Ind. 387, 35 N. E. 699 (1893); see (1927) 16 CALIF. L. REV. 162.

16. See statutes cited in notes following.

17. R. I. GEN. LAWS (1923) § 5554.

18. "The report of the committee disclosed that thirty-one (31) states had a uniform descent and distribution table and that ten (10) additional states had tables of descent and distribution which were uniform as to distributees but different as to the shares of the surviving spouse." Since that date New York and Ohio have also abolished the distinction between realty and personalty. 16 A. B. A. J. 785 (1930). Delaware, New Jersey, North Carolina and Tennessee have separate tables. DEL. REV. CODE (1915) §§ 3267, 3382; N. J. COMP. STAT. (Cum. Supp. 1925) §§ 57, 146-168; N. C. ANN. CODE (1931) §§ 137, 1654; TENN. CODE (Shannon, 1932) §§ 8389, 8380.

19. Jenks v. Estate of Trowbridge, 48 Mich. 94 (1882); see Kelly's Heirs v. McGuire, 15 Ark. 555, 594 (1855); Estate of Kirkendall, 43 Wis. 167, 175 (1877). *Contra:* Purcell v. Sewell, 134 So. 476 (Ala. 1931); Rountree v. Pursel, 11 Ind. App. 522, 39 N. E. 747 (1894).

20. ILL. REV. STAT. (Smith-Hurd 1931) c. 39 § 1; IOWA CODE (1931) §§ 11986-12040; KAN. REV. STAT. ANN. (1923) c. 22 § 128; ME. REV. STAT. (1930) c. 89 §§ 1, 2, 20; MASS. GEN. LAWS (1921) c. 190 §§ 1-4; N. H. PUB. LAWS (1926) c. 307 §§ 1-19; N. M. ANN. STAT. (1929) c. 38 §§ 101-120; N. Y. CONS. LAWS (Cahill, 1930) c. 13 §§ 81, 83; OHIO ANN. GEN. CODE SUPP. (Page, 1932) §§ 10503-1, 10503-4; ORE. ANN. CODE (1930) c. 10 §§ 101, 102, 203; PA. ANN. STAT. (Purdon, 1930) c. 20 §§ 62, 75; VT. GEN. LAWS (1917) §§ 3416, 3417; WASH. COMP. STAT. (Remington, 1922) §§ 1341, 1347, 1364.

21. ALA. ANN. CODE (1928) § 7369; CAL. PROB. CODE (Deering, 1931) § 254; IDAHO COMP. STAT. (1919) § 7796; MICH. COMP. LAWS (1929) § 13444; MINN. STAT. (Mason, 1927) § 8725; MONT. REV. CODES (Choate, 1921) § 7081; NEB. COMP. STAT. (1929) c. 30 § 111; NEV. COMP. LAWS (Hillyer, 1929) § 9862;

possess statutes approximating the Oklahoma statute which reads, "Kindred of the half blood inherit equally with those of the whole blood of the same degree unless the inheritance come to the intestate by descent, devise or gift of some one of his ancestors, in which case all those who are not of the blood of such ancestors must be excluded from such inheritance."[22] Under this type of statute in default of kindred of the blood of the ancestor, the half blood not of the blood of the ancestor have been permitted to take equally with whole blood of the same degree.[23] The decisions are in conflict as to whether the intestate's kindred of the blood of such ancestor take the inheritance in preference to closer kin of the half blood not of the blood of the ancestor.[24] Those cases which prefer the nearest of kin to the intestate, applying the ancestral distinction only as against those of the same degree seem more in harmony with the general purpose of the intestate statutes to favor the nearest of kin to the intestate.

The remaining states do not consider the source of the intestate's title in distributing his estate but discriminate against the half blood in various ways. Arizona, Colorado, Florida, Kentucky, Missouri, Texas, Virginia, West Virginia and Wyoming provide that within the same collateral degree the kindred of the whole blood shall receive twice as much as those of the half blood.[25] In the event that all the heirs of the nearest class are of the half blood, Arizona, Colorado, Texas and Wyoming grant them the portion they would have received had they been of the whole blood. Florida, Kentucky, Missouri, Virginia and West Virginia give the half blood whole portions but double the allotment to ascendants. Connecticut and Mississippi merely postpone the half blood to the whole blood in equal

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N. D. COMP. LAWS ANN. (1913) § 5752; OKLA. STAT. (1931) § 1626: S. D. COMP. LAWS (1929) § 710; UTAH COMP. LAWS (1917) § 6420; WIS. STAT. (1931) c. 237 § 3. See *supra*, note 8 for the six states excluding whole blood as well as half blood.

22. OKLA. STAT. (1931) § 1626.

23. Edwards' Estate, 259 Pac. 440 (1927). *Cf.* N. C. ANN. CODE (1931) § 1654 (5) expressly providing for inheritance by kindred not of the blood of ancestor in default of kindred of his blood.

24. Belshaw's Estate, 190 Cal. 278, 212 Pac. 13 (1923) (half blood not of blood of ancestor takes in preference to whole blood of blood of ancestor but in remoter degree to decedent); Pond v. Irwin, 113 Ind. 243, 15 N. E. 272 (1888); *cf.* Ryan v. Andrews, 21 Mich. 229 (1870) (maternal grandmother not of blood of ancestor takes in preference to kindred of half blood blood of ancestor but of remoter degree). *Contra:* Kelly's Heirs v. McGuire, 15 Ark. 555 (1855); Thompson v. Smith, 102 Okla. 150, 227 Pac. 77 (1923); Perkins v. Simonds, 28 Wis. 90 (1871); Rotenbach v. Young, 119 Misc. 267, 196 N. Y. Supp. 220 (1922), *aff'd*, 206 App. Div. 775, 200 N. Y. Supp. 946; 237 N. Y. 620, 143 N. E. 767 (1924). The Alabama statute is expressly limited to apply only to those of the same degree. Cox v. Clark, 93 Ala. 400, 9 So. 457 (1890).

25. ARIZ. REV. CODE ANN. (Struckmeyer, 1928) § 981; COLO. ANN. STAT. (Courtright's Mills, 1930) § 7840; FLA. COMP. LAWS ANN. (1927) § 5486; KY. STAT. (Carroll, 1930) § 1395; MO. REV. STAT. (1929) § 309; TEX. STAT. (1928) § 2573; VA. ANN. CODE (1930) § 5265; W. VA. OFF. CODE (1931) c. 42, art 1, § 2; WYO. REV. STAT. (1931) c. 88 § 4003.

degree.[26] In South Carolina, half brothers and sisters are postponed to brothers and sisters of the whole blood, but kindred of the half blood in more remote degrees of consanguinity are permitted to share equally with others in their own degree.[27] New Jersey and Delaware likewise prefer brothers and sisters of the whole blood to brothers and sisters of the half blood.[28] In the absence of kindred of the whole blood, however, and in the event that the estate is ancestral, only those half blood take who are of the blood of the ancestor. Louisiana discriminates between brothers and sisters of the whole and half blood in a different manner.[29] The estate is divided into paternal and maternal halves. Brothers and sisters of the whole blood share in both halves while those of the half blood share in their respective halves only. Georgia postpones the half blood on the maternal side to the whole blood on the paternal side.[30] Statutes in Colorado and Wyoming provide that "children and descendants of children of the half blood" inherit equally with those of the whole blood.[31] Since a child cannot be of the half blood of either of its parent the term "children" has been construed as "kindred."[32]

The tendency to abolish the doctrine of ancestral estate seems desirable, and perhaps other jurisdictions may be expected to follow the recent examples of New York and Ohio in so doing. The prevailing type of statute dealing with the doctrine is very obscurely phrased and fails to cover the various problems; its amendment into more explicit and inclusive terms would seem indicated in jurisdictions still wishing to retain the doctrine in this form. If ancestral estate be eliminated, the problem of relatives of the half blood is a comparatively simple one from the administrative point of view, although, their precise ideal position in the intestate scheme is not obvious.

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26. CONN. GEN. STAT. (1930) § 4982; MISS. ANN. CODE (1930) § 1403; *cf.* MD. ANN. CODE (Bagby, 1924) art. 93, § 24.

27. S. C. CODE OF LAWS (1932) § 8906.

28. N. J. COMP. STAT. (Cum. Supp. 1925) § 57-5; DEL. REV. CODE (1915) § 3267. Delaware also prefers brothers and sisters of the whole blood to those of the half blood as to realty and personalty.

29. LA. ANN. CIV. CODE (Dart, 1932) § 913. Thus if there are two brothers of the whole blood and a brother of the half blood on the father's side, the brothers of the whole blood would take five-sixths of the estate. *Cf.* King v. Neely, 14 La. Ann. 160, 163 (1859).

30. GA. ANN. CODE (Michie, 1926) § 3931.

31. *Supra*, note 25.

32. Finley v. Abner, 129 Fed. 734 (C. C. A. 8th, 1904).

THE RATE REGULATION OF FIRE INSURANCE COMPANIES

DURING the period when public attention was focused with emphatic disapproval on large industrial combinations, the business of fire insurance had already attained sufficient size to merit consideration. The general policy of fire insurance companies entering a certain territory was to combine into an association for the purpose of establishing uniform rates, and thereby to avoid the considerable expense necessitated by the creation of a special rating bureau for each company. It was this membership in rating bureaus, coupled with the resulting uniformity of rates, which brought fire insurance companies within the provisions of the state anti-trust laws.

In defeating criminal prosecutions for violation of state anti-trust statutes,[1] the fire insurance companies have been signally unsuccessful.[2] Indictments, it is true, have been held insufficient,[3] but in one instance at least, a sufficient indictment was later returned, and fines were imposed on the companies totalling over $8,000,000.[4] Nor have the companies been better able to defeat petitions for a writ of ouster,[5] or for the appointment of a receiver[6] sought by the state for anti-trust violations. Where the companies have applied for an injunction to restrain enforcement of an anti-trust statute, the constitutionality of the act has been directly tested.[7] But even here, the Supreme Court, through Mr. Justice Holmes, has upheld the constitutionality of such legislation on the ground that the state may, without transgressing the Fourteenth Amendment, take such steps as seem necessary for the preservation of competition.[8] Again, on

1. Combinations of fire insurance companies to restrict competition were not considered criminal at common law. People v. Aachen & Munich Fire Insurance Co., 126 Ill. App. 636 (1906); Aetna Insurance Co. v. Commonwealth, 106 Ky. 864, 51 S. W. 624 (1899); Harris v. Commonwealth, 113 Va. 746, 73 S. E. 561 (1912).

2. *In re* Pinkney, 47 Kan. 89, 27 Pac. 179 (1891) (habeas corpus proceedings); State v. Phipps, 50 Kan. 609, 31 Pac. 1097 (1893). See State v. American Surety Co., 91 Neb. 22, 135 N. W. 365 (1912).

3. Fire Insurance Companies v. State, 75 Miss. 24, 22 So. 99 (1897).

4. Aetna Insurance Co. v. Robertson, 131 Miss. 343, 94 So. 7 (1922).

5. State v. Firemen's Fund Insurance Co., 152 Mo. 1, 52 S. W. 595 (1899).

6. Aetna Insurance Co. v. Robertson, 126 Miss. 387, 88 So. 883 (1921) (suit at instance of revenue agent, who sought attachment of companies' property). In Miller v. Fidelity Union Fire Insurance Co., 126 Miss. 301, 88 So. 711 (1921), a bill to collect the statutory penalty for violation was dismissed because of insufficient averment of the unlawful agreement. See McCarter v. Firemen's Insurance Co., 74 N. J. Eq. 372, 73 Atl. 80 (1909) (injunction sought by attorney general).

7. Niagara Fire Insurance Co. v. Cornell, 110 Fed. 816 (C. C. D. Neb. 1901) (statute held unconstitutional).

8. Carroll v. Greenwich Insurance Co., 199 U. S. 401 (1905). Another method of control adopted was a penalty, paid to the insured, because of a company's membership in a tariff association. The measure of the penalty was generally 25% in excess of the stated loss. Continental Insurance Co. v. Parkes,

the theory that the state has the power to prescribe terms for foreign corporations doing business within the state, it has been held that a license may be forfeited for an illegal combination to fix rates,[9] even though the combination was entered into outside the state and no attempt was made to set the rates within the particular state.[10]

Although the enforcement of anti-trust legislation against fire insurance companies has met with striking success,[11] the policy has proven ill advised. An uncontrolled rating bureau and a uniformity of rate structure may well indicate the presence of an undesirable combination to restrict competition. But it is clear that the maintenance of one organization, the purpose of which is to fix rates within a state, is far more economical than the forced establishment of a separate rating bureau for each company, which would not only result in considerable waste, but would enlarge the opportunities for inaccurate determination of risks. Then too, it was soon realized that competition, with its concomitant rate wars, was distinctly adverse to the public interest, which was as much concerned with the securing of premiums adequate to maintain unimpaired reserves as with protection from excessive rates. For these reasons, the states have abandoned the policy of enforcing competition in fire insurance rates, and have sought to establish some method of rate regulation. This has generally been accomplished by allowing the companies' rating bureau to function under state supervision, or by empowering the state insurance commission to establish its own rates.

Since 1914, when the constitutionality of fire insurance rate regulation was definitely established,[12] little progress has been made toward the attainment of effective regulation. Inasmuch as there has appeared a strong tendency to proceed according to the established principles of public utility regulation, an analysis of the problems which are presented, and the results which have been reached, must necessarily be developed by analogy to the

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142 Ala. 650, 39 So. 204 (1905). But the penalty has been as large as 25% of the face value of the policy. Southern States Fire Insurance Co. v. Kronenberg, 199 Ala. 164, 74 So. 63 (1917). This regulatory device was held constitutional in German Alliance Insurance Co. v. Hale, 219 U. S. 307 (1911).

9. Hartford Fire Insurance Co. v. Raymond, 70 Mich. 485, 38 N. W. 474 (1888).

10. Hartford Fire Insurance Co. v. State, 76 Ark. 303, 89 S. W. 42 (1905), overruling State v. Lancashire Insurance Co., 66 Ark. 466, 51 S. W. 633 (1899).

11. Only in suits by an individual, expelled from a tariff association because of violations of its by-laws, have the companies been able to defend themselves with general success. Continental Insurance Co. v. Board of Fire Underwriters, 67 Fed. 310 (C. C. N. D. Cal. 1895); Beechley v. Mulville, 102 Iowa 602, 71 N. W. 428 (1897); People v. N. Y. Board of Fire Underwriters, 7 Hun 248 (N. Y. 1876). The apparent reason for this is the fact that the plaintiff has not directly attacked the legality of the association, and therefore the courts have not felt obligated to pass on the question. Louisville Board of Fire Underwriters v. Johnson, 133 Ky. 797, 119 S. W. 153 (1909).

12. German Alliance Insurance Co. v. Lewis, 233 U. S. 389 (1914), *aff'g* German Alliance Insurance Co. v. Barnes, 189 Fed. 769 (C. C. D. Kan. 1911).

familiar regulatory concepts of net income, the rate of return, and the rate base.

The rough formula which has generally been adopted by courts and commissions for the measurement of gross income from premiums charged is that of "net premiums written" for the period under consideration.[13] By this is meant earned plus unearned permiums.[14] The insurance companies have strenuously urged that only earned premiums should be considered, on the ground that unearned premiums, required by law to be set up in a reserve to meet losses and cancellations on unexpired policies, should be treated as a liability rather than as income.[15] The premiums charged are designed to yield the company an amount sufficient to cover the basic actuarial calculation as to losses and cancellations, expenses incident to underwriting, and profit. These elements, however, appear not only in the earned, but also in the unearned portion of the premiums collected. Thus all of the unearned premiums should not be considered as a reserve for losses and cancellations. The companies are apparently correct in their contention that that portion of unearned premiums reserved for losses and cancellations cannot be regarded as true income until the period for which the risk was assumed has expired.[16] This contention also seems correct as applied to profit, which cannot be considered as earned until the equivalent service of risk-bearing has been performed, or in other words, until the premium has become earned. Only that element of unearned premiums representing the allowance for expenses may properly be re-

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13. Aetna Insurance Co. v. Travis, 121 Kan. 802, 257 Pac. 337 (1926); Aetna Insurance Co. v. Hyde, 315 Mo. 113, 285 S. W. 65 (1926), writ of certiorari dismissed, 275 U. S. 440 (1928) (no federal question presented, inasmuch as the companies had sued jointly upon the ground that the aggregate collections under the reduced rates ordered by the state of Missouri were confiscatory, and yet had failed to show that the reduced rates were confiscatory as to any one company. Mr. Justice Butler declared that "It has never been and cannot reasonably be held that state-made rates violate the Fourteenth Amendment merely because the aggregate collections are not sufficient to yield a reasonable profit or just compensation to all companies that happen to be engaged in the affected business"); Aetna Insurance Co. v. Hyde 34 F. (2d) 185 (W. D. Mo. 1929) (separate actions filed subsequent to the Supreme Court decision in 275 U. S. 440, and challenging the validity of the same Missouri order for the reduction of rates); see Note (1930) 15 ST. LOUIS L. REV. 400, 407.

14. Earned premiums are that part of total premiums, all of which have been paid in advance by the policyholders, chargeable to the elapsed portions of the outstanding policies; unearned premiums are that part allocatable to the unelapsed portions of such policies. For facilitating the calculation, at the end of a business period, of the earned and unearned portions of policies exceeding one year in duration, the Box Fraction Formula is employed, whereby all policies are regarded as dating from the middle of the year in which they were issued.

15. The companies have secured a favorable ruling on this in one instance. Bullion v. Aetna Insurance Co., 151 Ark. 519, 237 S. W. 716 (1922).

16. 2 GEPHART, PRINCIPLES OF INSURANCE (1920) 215; HUEBNER, PROPERTY INSURANCE (1925) 217, 218.

garded as income for the period under consideration, since the greater part of the services covered by the charge for expenses are rendered within six months from the date of issuance of the policies. Therefore, the inclusion of unearned premiums as part of the gross income seems to be proper provided that there is deducted an amount equal to the reserve which must be maintained against losses and cancellations on unexpired policies, plus the estimated profit element in unearned premiums.[17]

There is the further problem of the inclusion of income from investments in the computation of gross income. Invested funds are composed of contributions by the owners, or capital stock, and the reserves derived from paid-in premiums. The tendency has been to include income from invested reserves.[18] However, in only two cases has the income from invested capital contributions been considered,[19] and in one of these instances only indirectly, merely as a means of checking the reasonableness of the rates previously ascertained.[20] The view that income from invested funds, whether from contributed capital or reserves, should be excluded from consideration, is based on the supposed distinction between the investment and the underwriting branches of the fire insurance business. This distinction seems unsound in view of the facts that indemnification of the public against loss is the sole function performed by the companies, and that the entire invested capital is utilized in the performance of this function. Certainly, at least, the income from reserves created from contributions by the policyholders themselves should be included in gross income.

In the calculation of deductions to be allowed from gross income, there appear for consideration two elements of cost, losses and expenses. One means of computing losses, advocated by the companies and adopted by at least one court,[21] is the incurred loss method, whereby there are added to all losses paid during the particular period, unpaid losses outstanding at

17. The Virginia State Corporation Commission has ruled that unearned premiums are to be included in gross income with a deduction allowed for actual liability on unexpired policies. It thus holds that the allowances for both the expense and profit elements are to be regarded as true income for the period in which unearned premiums are received. Commonwealth v. Aetna Insurance Co., VIRGINIA STATE CORPORATION COMMISSION (1929) 15.

18. Aetna Insurance Co. v. Travis, 124 Kan. 350, 259 Pac. 1068 (1927); Aetna Insurance Co. v. Hyde, 315 Mo. 113, 285 S. W. 65 (1926); Commonwealth v. Aetna Insurance Co., *supra* note 17. *Contra:* Aetna Insurance Co. v. Hyde, 34 F. (2d) 185 (W. D. Mo. 1929) (express holding); Bullion v. Aetna Insurance Co., *supra* note 15 (omission of any consideration of this type of income).

19. Aetna Insurance Co. v. Travis, *supra* note 18; Commonwealth v. Aetna Insurance Co., *supra* note 17. In the other cases thus far litigated, income from contributions of the owners has been expressly excluded in rate making calculations. Aetna Insurance Co. v. Hyde, 34 F. (2d) 185 (W. D. Mo. 1929); Aetna Insurance Co. v. Hyde, 315 Mo. 113, 285 S. W. 65 (1926); Bullion v. Aetna Insurance Co., *supra* note 15.

20. Commonwealth v. Aetna Insurance Co., *supra* note 17.

21. Bullion v. Aetna Insurance Co., *supra* note 15.

the end of the period; from this are deducted unpaid losses outstanding at the beginning of the period. The paid loss method, subscribed to by the majority of the courts,[22] takes into account solely the losses actually paid out during the period. The "incurred" method, as employed by the companies in their accounting, involves the use of estimates of outstanding losses, which, however, are never corrected to accord with actual payments made. Yet because of defective claims, settlements, etc., actual payments made are generally less by some 10% than the estimated incurred losses.[23] The "paid" method is erroneous in that it involves the assumption that outstanding losses unpaid at the beginning are the same as those at the end of the period; in a great number of instances, there results from this assumption a substantial error in the computation of the total amount of losses actually paid out for a given period.[24] A more accurate means of computing losses would seem to be the adoption of the "incurred" method, and at the same time the correction of estimated incurred losses to conform to the actual payments later made.[25] In the determination of expenses, the attitude of the courts is substantially the same as for losses, and like criticisms apply to the methods employed. There is one added difficulty, however, in that underwriting expenses must be separated from expenses of managing investments, if only the underwriting branch is to be considered for rate making purposes. In this connection, the presence of joint expenses necessitates some method of proration. The companies have suggested that the mean invested assets be used as the basis; but there still remains the problem of determining accurately what percentage of this figure is to be utilized.

Just as the prevailing conception of the two distinct functions of underwriting and banking has led in the majority of instances to the exclusion of investment income from the determination of gross income, so has it generally resulted in the adoption of net premiums written as a rate base.[26] Obviously, the profitableness of a financial venture depends on the return secured to the contributed capital. But it is not clear what relation net premiums written would bear to invested capital. Therefore, it is by no means certain that a return allowed with reference to such a rate base

22. See note 13, *supra*.

23. Approximately 10% is the usual figure given. See Aetna Insurance Co. v. Travis, *supra* note 13, at 805, 257 Pac. at 342. The Virginia State Corporation Commission, however, found a much greater disparity. Commonwealth v. Aetna Insurance Co., *supra* note 17, at 78.

24. The courts adopting the "paid" method assume that over a period of years this error is insignificant. Aetna Insurance Co. v. Hyde, 34 F. (2d) 185, 200 (W. D. Mo. 1929). Such an assumption seems hazardous, however, and not conducive to accurate calculations.

25. This method is employed by the Virginia State Corporation Commission. Commonwealth v. Aetna Insurance Co., *supra* note 17.

26. Aetna Insurance Co. v. Hyde, 34 F. (2d) 185 (W. D. Mo. 1929); Aetna Insurance Co. v. Hyde, 315 Mo. 113, 285 S. W. 65 (1926); Bullion v. Aetna Insurance Co., *supra* note 15; Commonwealth v. Aetna Insurance Co., *supra* note 17. *Contra:* Aetna Insurance Co. v. Travis, *supra* note 18.

alone would be sufficient to warrant the attraction of new capital to the enterprise. The only way in which net premiums written can have significance is by relation to the return upon the total capital investment. So fundamental is the concept of a return upon contributed capital as the measure of reasonableness, that courts and commissions may find themselves necessarily drawn to the use of invested capital as a rate base. Indeed, one court has entirely rejected the principle of net premiums written in favor of invested capital.[27] And the Virginia Corporation Commission, although employing net premiums written as the base, felt the need of testing the reasonableness of the rates ordered by determining whether the proposed underwriting profits, added to investment income, would yield a reasonable return on "Virginia fire capital, surplus and undivided profits."[28] The selection of invested capital as a rate base, however, would raise certain problems not presented by the use of net premiums written. The fact that most of the companies submitting to state regulation are interstate in character, would necessitate the adoption of some method of allocating the proper amount of total invested capital to the state in question. Probably the most accurate measure would be the ratio of total net premiums to net premiums written within the state.[29] Furthermore, the use of invested capital would raise the prudent investment—present value problem,[30] with all the disadvantages arising from the confusion now prevalent in the public utility field. However, these disadvantages might possibly be mitigated by the greater ease of valuation in the business of fire insurance.[31]

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27. Aetna Insurance Co. v. Travis, *supra* note 18. See note 26, *supra*.

28. Commonwealth v. Aetna Insurance Co., *supra* note 17, at 118, 119. The necessity of resorting to return on invested capital to find a valid measure of reasonableness is appreciated by writers on the subject of fire insurance rate regulation. PATTERSON, THE INSURANCE COMMISSIONER IN THE UNITED STATES (1927) 282; RUMSEY, THE STATE AND THE INSURANCE COMPANY (1914) 12.

29. In the two cases in which the necessity for allocating capital has presented itself, this method has been employed. Aetna Insurance Co. v. Travis, *supra* note 18; Commonwealth v. Aetna Insurance Co., *supra* note 17.

30. That this would very likely be true is indicated by the opinion in the one case wherein capital investment has been adopted as the rate base. Aetna Insurance Co. v. Travis, *supra* note 18, at 356, 357, 259 Pac. at 1071, 1072.

31. Another criticism of such a rate base has been advanced in Note (1928) 41 HARV. L. REV. 532. It is there contended that the use of capital investment would discourage insurance companies from seeking additional policyholders, since the failure of the capital investment to increase commensurately with the business prevents management from receiving any reward for its efforts toward expansion. The contention is predicated upon the assumption that in the insurance business, invested capital remains static after the initial contribution, regardless of the volume of insurance later written, whereas in the case of the public utilities, capital investment is always roughly commensurate with the amount of business done. The assumption made, however, is scarcely accurate as to either utilities or insurance. That in the former there is a direct relation between the amount of invested capital and the volume of business done is true only in a limited sense, since utilities operate under

The selection of an adequate rate of return is of paramount importance because of the complete dependence of policyholders upon the invested capital and reserves. To secure a fair and reasonable return, a different rate would be necessary on net premiums written than on invested capital. Similarly, a rate allowed on the entire business would be at variance with a rate established solely on the underwriting division, since if a rate proper for the entire business were utilized with reference to underwriting alone, the companies would reap an unreasonable profit through the disregarding of the interest gained on investments.[32] There is the further problem of making provision in the rate for an allowance to cover losses arising from conflagrations. Such losses cannot be anticipated in actuarial calculations because of the irregularity of their occurrence. Allocation of such losses is extremely difficult in that it seems desirable to apportion them among the several states, rather than to place the burden entirely upon the state in which the conflagration occurs. The problem of whether the reward for risk-bearing in the rate embraces this element, clearly resolves itself into a question of the adequacy of the original allowance for risk.[33]

It may be seen that state control of the price of fire insurance has been attempted under two utterly divergent economic theories. The enforcement of competition through the application of anti-trust legislation has given way to restriction of competition through rate regulation. But although enforcement of competition has proven unworkable, restriction has also failed to give promise of adequate public protection. By the very

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conditions of decreasing cost. On the other hand, the surplus set aside by insurance companies is increased as the amount of insurance outstanding becomes greater, and such increased surplus is a proper part of the total invested capital, for it consists of earnings reinvested in the business by the owners. It has been considered as a portion of total invested capital in both the cases wherein the question was relevant. Aetna Insurance Co. v. Travis, *supra* note 18; Commonwealth v. Aetna Insurance Co., *supra* note 17. Moreover, in regulatory practice the reward of good management, if deemed desirable, is customarily secured through a differential allowance in the rate of return. SMITH, THE FAIR RATE OF RETURN IN PUBLIC UTILITY REGULATION (1932) 198.

32. The rate uniformly employed under present regulatory methods which involve the use of net premiums as a rate base and include in rate regulation only the underwriting portion of the business, is 5%.

33. The Arkansas court has felt that the 5% basic rate sufficiently covers the conflagration hazard. Bullion v. Aetna Insurance Co., *supra* note 15. Apparently the Kansas court has taken the same view; at least no additional amount was recommended by the referee and there was no further mention of the matter by the court. Aetna Insurance Co. v. Travis, *supra* note 13. On the other hand, the Missouri Supreme Court allowed 3% for this hazard over the basic 5%; the Federal District Court an additional amount although the exact percentage is not given; the Virginia State Corporation Commission 2¼%. Aetna Insurance Co. v. Hyde (both cases), *supra* note 13; Commonwealth v. Aetna Insurance Co., *supra* note 17. The companies have contended for an allowance of 3% in addition to the 5% rate.

complexity of fire insurance, the companies have in great measure been protected from effective price control. But more important than the prevention of excessive profits, from the standpoint of the policy holders, is a guaranty of financial stability. Therefore, in proceeding with a program of regulation about which little is comprehended, there is added to the problem of avoiding unreasonable profit, the danger that the very solvency upon which the public is dependent may be seriously threatened by the blind application of an untested theory.[34]

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34. One of the most interesting illustrations of the relation between anti-trust legislation and rate regulation is the recent situation in Texas, where the insurance companies were held to have violated the anti-trust act by combining to regulate commissions paid to agents, despite the fact that the State Insurance Commissioner had full power to regulate rates. Potomac Fire Insurance Co. v. State, 18 S. W. (2d) 929 (Tex. Civ. App. 1929). The following year, an order of the Insurance Commission limiting the amount of commissions to be paid agents was held invalid on the ground that the power to set maximum rates did not carry with it the power to control the elements comprising the rate. Commercial Standard Insurance Co. v. Board of Insurance Commissioners, 34 S. W. (2d) 343 (Tex. Civ. App. 1930).